IN THE

Supreme Court of the United States

No. 76-1119

KLINE D. STRONG,
Petitioner,

vs.

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

HOLLAND & HART
Edwin S. Kahn
500 Equitable Building
730 Seventeenth Street
Denver, Colorado 80202

Counsel of Record for Petitioner

TABLE OF CONTENTS

TABLE OF CITATIONS
CASES CITED

TABLE OF CITATIONS (CONTINUED)

RULES AND STATUTES CITED

RULES AND STATUTES CITED (CONTINUED)

OTHER AUTHORITIES CITED

IN THE

Supreme Court of the United States

No. ____________

KLINE D. STRONG,
Petitioner,

vs.

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review the judgment herein of the United States Court of Appeals for the Tenth Circuit entered in the above-entitled case on September 29, 1976, application for rehearing denied on November 16, 1976.

OPINIONS BELOW

The United States District Court for the District of Utah entered no opinion, but the Findings of Fact and Conclusions of Law and the Decree entered by the District Court are set out in Appendix A and Appendix B, respectively.

The opinion of the United States Court of Appeals for the Tenth Circuit reversing the judgment of the District Court is set out in Appendix C. Although not officially reported, the opinion has been reported at [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,465 (10th Cir. 1976).

The opinion of the United States Court of Appeals for the Tenth Circuit reversing the original judgment of the Court of Appeals and reinstating the judgment of the District Court is set out in Appendix D. Although not yet officially reported, the opinion has been reported at [Current Binder] CCH Fed. Sec. L. Rep. ¶95,744 (10th Cir. 1976).

The Order of the Court of Appeals denying petitioner's application for rehearing is set out in Appendix E.

JURISDICTION

The judgment of the Court of Appeals (Appendix D) was entered on September 29, 1976, and petitioner's application for rehearing was denied on November 16, 1976 (Appendix E). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1966).

QUESTIONS PRESENTED

1. Did the Court of Appeals err in holding, contrary to the determinations of other Courts of Appeals, that a plaintiff in a civil action under SEC Rule 10b-5 need not show <u>any</u> degree of care or diligence in order to sustain his claim?

2. Did the Court of Appeals err in holding, contrary to the federal "out of pocket" loss rule, that a plaintiff need not demonstrate <u>any</u> pecuniary injury in order to sustain a claim for rescission in a civil action under SEC Rule 10b-5?

3. Did the Court of Appeals err in holding, contrary to Utah law, that a plaintiff need not show <u>any</u> degree of care or <u>any</u> pecuniary injury in order to sustain a claim for rescission under common law fraud?

STATUTES INVOLVED

1. The statutory provision involved is 15 U.S.C. § 78j (b) (1972):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. The federal regulation involved is 17 C.F.R. § 240.10b-5 (1976), which provides:

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme or artifice to defraud.

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

After trial to the Court in December, 1974, Judge Willis Ritter, sitting without a jury, mechanically adopted the findings of fact prepared by the Holdsworths' attorneys and entered judgment for the Holdsworths.

The original panel of the Court of Appeals reversed the judgment of the District Court, because the Holdsworths had not exercised any care or diligence and because the Holdsworths had not proven any pecuniary injury. Thereafter, the Court of Appeals, en banc, reversed the determination of the original panel holding that (i) exercise of care or diligence is not a requirement for recovery in a civil action under Rule 10b-5, (ii) that pecuniary injury is not a requirement for rescission in a civil action under Rule 10b-5, and (iii) that neither exercise of care nor pecuniary injury are requirements for rescission under Utah common law fraud. Petitioner seeks to have this Court review these significant rulings.

Petitioner adopts herein the concise, accurate, and uncontroverted statement of the facts in this case set out by the original panel of the Court of Appeals in its opinion (Appendix C), as follows:

"In 1959 appellant Kline D. Strong, appellee K. Jay Holdsworth and Paul Tanner formed a corporation named Sans-Copy. Initially 60 shares of common capital stock were issued. The 60 shares eventually were divided as follows: 20 shares to appellant and his wife; 20 shares to Holdsworth and his wife (appellees); and 20 shares to Tanner and his wife. The sum of $300 was paid for each block of 20 shares. The purpose of the corporation was to develop, manufacture and market timekeeping systems for law offices.

"Sans-Copy entered into an agreement with Reynolds & Reynolds Company in 1959; Reynolds &

Reynolds was granted the exclusive rights to manufacture and market Sans-Copy timekeeping systems except that marketing in Utah and Arizona was to be done by Sans-Copy itself. Sans-Copy was to receive a royalty on all sales, varying from 30% downward. The agreement required appellant to promote Sans-Copy systems at bar associations' meetings.

"Also in 1959, the ordinary common stock of the corporation was increased to 100 shares. Following allocation of the new shares, stock holdings were as follows: appellant and his wife, 52 shares; the appellees, 22 shares; the Tanners, 22 shares; and Robert Shirley (an employee of Tanner), 4 shares. From 1959 to 1962, no dividends were paid to the holders of this ordinary common stock; in fact, no dividends have ever been paid to holders of this stock.

"In 1962, a new type of stock was issued by Sans-Copy. This non-voting Class A common stock provided a means to compensate Holdsworth and Tanner who were not engaged in the corporation's work. The Class A stock was given a noncumulative dividend preference over the ordinary common stock to the extent of $70 per share. The appellees and the Tanners received 30 shares of the new stock per couple; $300 was given for 30 shares. Sans-Copy's board of directors approved a resolution that appellant

> . . . should be compensated for his services commensurate with the value of his services to the Corporation in such amount or amounts as the Board of Directors may from time to time determine.

Dividends were paid sporadically on this Class A stock until 1970.

"On January 12, 1971, appellant wrote Holdsworth and Tanner the following letter:

> I was just advised by the accountants for Sans-Copy that we have declared in dividends for 1970 more funds than we had in surplus. In other words, we have declared some $200 or $300 out of capital.
>
> For obvious reasons, although nothing will be done about 1970, we will not be declaring any dividends for a month or two. I am sure you both understand the necessity for this action.

"On January 19, 1972, Holdsworth and appellant were in Holdsworth's office discussing problems concerning a ranch they owned which was supervised by Holdsworth. Appellant told Holdsworth he desired to acquire all the Sans-Copy stock held by the Holdsworth family for $1500. Holdsworth testified that appellant said:

> . . . the corporation has not paid dividends the last year because it couldn't, it didn't have any income, and he was satisifed the corporation would never pay any dividends that would in any way help me with any of the cash requirements that I had . . . .

"This oral proposal was followed by a letter from appellant to Holdsworth on January 21, 1970 [sic]. In that letter appellant mentioned he had made a purchase offer to Tanner. In discussing certain details of the transaction, appellant wrote, 'As I have indicated to you previously, I doubt that there will be any dividends in the future. . . .' The Tanners sold their stock. Appellant paid $500 for the 22 shares of Sans-Copy ordinary common stock and Sans-Copy redeemed the Tanners' 30 shares of Class A stock for $1000.

"The appellees sold all interests they had to sell in their stock in the first part of 1974 [sic]. The Strongs agreed to release and indemnify Holdsworth from any

and all liabilities that might arise from his having been a director, shareholder, secretary and treasurer of Sans-Copy and having been a trustee for Sans-Copy's employee profit sharing plan. A release was also secured from all claims for reimbursement for salaries and expenses paid by Sans-Copy to Claude Clark (Mrs. Strong's uncle) when he worked on the ranch owned by Holdsworth and appellant.

"On May 17, 1973, the appellees made a formal demand on appellant that the sale of their Sans-Copy stock be rescinded. Appellant rejected that demand. On May 31, 1973, appellees commenced suit against appellant." [Footnotes omitted].

REASONS FOR GRANTING THE WRIT

I. The Court of Appeals incorrectly held, contrary to the decisions of other Circuits, that plaintiff need not show any care or diligence to succeed in a Rule 10b-5 action.

In the en banc opinion of the Court of Appeals (Appendix D), the Court noted:

> [T]he primary issue is, then, whether in an intentional fraud case such as the instant one, the victim is barred from relief if he does not exercise due care to avoid being deceived, due diligence being generally defined as the requirement that an insider "must fulfill a duty of due care in seeking to ascertain for himself the facts relevant to a transaction" before he may clain reliance on a material misrepresentation or omission . . . .

However, the Court of Appeals specifically declined to apply any standard of care or diligence. The Tenth Circuit held that the requirement of care or diligence was equivalent to the application of a "contributory

negligence" doctrine and that the requirement was thus inappropriate under *Ernst & Ernst v. Hochfelder*, 425 U.S. 285 (1976). This determination is directly contrary to *Straub v. Vaisman & Co.*, 540 F.2d 591 (3rd Cir. 1976), decided after this Court's decision in *Hochfelder*. The conflict between the Third and Tenth Circuits is thus clear, and that conflict concerns an issue critical to litigation under Rule 10b-5. The Tenth Circuit's determination is also contrary to numerous cases which preceded the *Hochfelder* decision. *E.g., Clement A. Evans & Co. v. McAlpine,* 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971).

Petitioner submits that the federal securities laws would best be served by retaining the requirement that a party must exercise due care or due diligence in determining the facts relevant to a transaction before he may recover in a civil action under Rule 10b-5. The many reasons supporting such a rule include the following:

1. Eliminating the requirement of care or diligence would permit reckless and inprudent investors to recover under Rule 10b-5. Indeed, because a plaintiff with actual knowledge of the facts cannot recover under Rule 10b-5, eliminating the due care requirement would place a premium on ignorance and would encourage investors to make no investigation of facts surrounding an investment decision.

2. The analogy to contributory negligence not being a defense to intentional fraud is too simplistic for Rule 10b-5 actions in light of the difficult proof of motivation and *scienter* and the fact that most securities cases are determined at trial rather than before trial.

3. The concept of due care and due diligence in Rule 10b-5 actions is compatible with standards under common law fraud in most jurisdictions. Without a more substantial indication of statutory intent, it would be

violative of federal-state relationships to hold that lesser standards in such important areas as the plaintiffs' care or diligence may sustain recovery in the Federal courts, where they would not do so in state courts or under state law.

4. The Securities Exchange Act of 1934 was intended to equalize the bargaining position of the investing public by making investment information available to all investors trading in the securities market.[1] Such availability of investment information affords investors the opportunity to be informed and to trade on equal footing with other investors. Informed investors increase the stability and credibility of the securities market and increase public confidence in the market and decrease speculation. Retaining the requirement that plaintiffs must exercise due diligence under Rule 10b-5 would increase the availability and circulation of investment information and would encourage investors to make use of that information in their securities dealings.

Moreover, where plaintiffs are officers and directors of the company at the time they sell their stock, as in this case, the requirement of care or diligence is essential. In such circumstances, plaintiffs must be charged with actual or constructive knowledge of the information contained in the company's books and records, and failure to exercise any care or diligence cannot be excused. *E.g., Myzel v. Fields,* 386 F.2d 718, 736 (8th Cir. 1967), *cert denied,* 390 U.S. 951 (1968). To eliminate the requirement of care or diligence in such circumstances would allow recovery to officers and directors who, as here, have breached their duty to be informed. *E.g.,* Utah Code Ann. §16-10-33 (Repl. 1973).

[1] S. Rep. No. 792, 73rd Cong., 2d Sess. 9 (1934).

II. The Court of Appeals incorrectly held, contrary to the decisions of other Circuits, that plaintiffs need not show any pecuniary injury to recover under Rule 10b-5.

The law traditionally has afforded remedies only to those that have been injured. In order to have a remedy under Rule 10b-5, plaintiffs must show that the stock relinquished was worth more than they were paid for it. *E.g., Rochelle v. Marine Midland Grace Trust Co. of New York,* 535 F.2d 523 (9th Cir. 1976); *Andrews v. Blue,* 489 F.2d 367, 376 (10th Cir. 1973); *Levine v. Seilon, Inc.,* 439 F.2d 328, 334-35 (2d Cir. 1971); *Slavin v. Germantown Fire Ins. Co.,* 174 F.2d 799 (3rd Cir. 1949).

Neither the District Court nor the Court of Appeals found that the stock relinquished by the Holdsworths in this case was worth more than they were paid for it. Indeed, the original panel of the Court of Appeals found that the Holdsworths had not shown any economic injury, and this finding was not challenged.

Eliminating the requirement of pecuniary injury from Rule 10b-5 actions would invite the very abuses about which this Court was concerned in *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975). Indeed, what legitimate purpose could a plaintiff have for bringing suit under Rule 10b-5 where he has not suffered pecuniary injury? Even the Restatement of Torts, the authority cited by most courts for implication of remedies under Rule 10b-5, requires a showing of harm before there can be liability. Restatement (Second) of Torts §286 (1965).

Thus, the Court of Appeals has applied a standard inconsistent with that of other circuits and, indeed, inconsistent even with its own prior determinations.

III. The Court of Appeals incorrectly held, contrary to the decisions of the Utah Supreme Court, that

plaintiffs need not show any degree of care or any pecuniary injury in order to sustain a claim for rescission under common law fraud.

The Utah Supreme Court has consistently held that in order to establish a fraud claim, plaintiffs must prove that they exercised reasonable care or diligence. *E.g., Douglas v. Duvall,* 5 Utah 2d 429, 430-31, 304 P.2d 373, 374 (1956); *Lewis v. White,* 2 Utah 2d 101, 269 P.2d 865, (1954). *See also Shappirio v. Goldberg,* 192 U.S. 232 (1904).

The Utah Supreme Court has also consistently held, regardless of whether legal or equitable relief is sought, that pecuniary injury is an essential element of plaintiffs' claim under common law fraud. *E.g., Child v. Hayward,* 16 Utah 2d 351, 400 P.2d 758 (1965); *Rummell v. Bailey,* 7 Utah 2d 137, 145, 320 P.2d 653, 659 (1958).

CONCLUSION

For the reasons set forth above, petitioner respectfully prays that a Writ of Certiorari issue to review the judgment herein of the United States Court of Appeals for the Tenth Circuit.

Respectfully submitted,

HOLLAND & HART
Edwin S. Kahn
500 Equitable Building
730 Seventeenth Street
Denver, Colorado 80202
(303) 292-9200

Counsel of Record for Petitioner

APPENDIX A

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF UTAH

CENTRAL DIVISION

K. JAY HOLDSWORTH and DONA S. HOLDSWORTH,
Plaintiffs,

vs.

KLINE D. STRONG,
Defendant.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

No. C-190-73

This cause came on regularly for trial on November 25, 1974, before the Honorable Willis W. Ritter, Chief Judge, without a jury.

The plaintiffs appeared personally and by their attorneys, Harold G. Christensen and R. Brent Stephens of Worsley, Snow & Christensen. The defendant appeared personally and by his attorneys, Clifford L. Ashton and Brent Stevenson of Van Cott, Bagley, Cornwall & McCarthy.

The court heard the testimony of witnesses and received exhibits offered by the parties and, after both had rested, heard argument of counsel and being fully advised, now makes and enters the following

FINDINGS OF FACT

1. Plaintiff K. Jay Holdsworth and defendant Kline D. Strong are members of the Bar of the State of Utah. They met in 1957 when defendant moved into the L.D.S. Ward in which plaintiffs were living. Defendant had just recently begun the practice of law and became interested in timekeeping systems for lawyers. He made inquiry of plaintiff K. Jay Holdsworth concerning the method

employed in his firm and made inquiry of other firms in Salt Lake City.

2. Thereafter, plaintiffs and defendant and his wife became close friends. Plaintiff K. Jay Holdsworth considered defendant his closest personal friend. They worked together in bar activities and in the development of a timekeeping system for lawyers.

3. By 1958 it was concluded that there was a market for a system consisting of time slips mounted on a peg board in such a staggered fashion (shingled) that the entry of the information on the slip would at the same time make a running journal, eliminating the necessity of copying the information from the time slips to get a daily total or from the running journal to get an amount to charge the individual client. It was determined from communication with Reynolds & Reynolds (PostRite, Inc.), a national marketer of peg board systems for accountants, that such a system was feasible although not then available to lawyers.

4. In 1959 plaintiff K. Jay Holdsworth, defendant and Paul B. Tanner, a local Certified Public Accountant, caused a Utah corporation known as Sans-Copy to be formed, each taking one-third of the 60 shares of common capital stock of that corporation. The name Sans-Copy was suggested by plaintiff K. Jay Holdsworth and was the only mark or product protectible under trademark, patent or copyright laws.

5. In July, 1959, the common capital stock of the corporation was increased to 100 shares. Defendant thereafter held 52 shares, plaintiff, 22 shares, Tanner, 22 shares, and an employee of Tanner, Robert E. Shirley, 4 shares.

6. Also, in 1959, it was determined that rather than attempt to market the system itself, it would be in the

interest of Sans-Copy to enter into a marketing agreement with Reynolds & Reynolds (PostRite, Inc.) which had national facilities for marketing accounting systems and which was willing to market the Sans-Copy System and pay a percentage of the receipts from sales to Sans-Copy. An agreement to this effect was entered into with Reynolds & Reynolds (PostRite, Inc.) reserving to Sans-Copy distribution in the states of Utah and Arizona.

7. In 1962, Shirley left Salt Lake and thereafter the book and record keeping and the receipt and the disbursement of the funds of Sans-Copy were by or under the direction of defendant. Although regular financial reports had been supplied by Shirley between 1959 and 1962, no financial reports were submitted after 1962 and no meetings of the directors were held after 1962 until after the filing of this action. After 1962 defendant as President and Chief Executive Officer of Sans-Copy personally controlled, directed and supervised all of the activities and affairs of Sans-Copy, both operational and financial.

8. By 1962 the receipts of Sans-Copy were sufficient to justify the payment of a salary to defendant. It was agreed that he would be paid such salary as the Board of Directors should from time to time determine. It was also agreed at that time that the corporation would issue a new class of common stock to be known as Non-voting Class A Common which should be preferred as to dividends over the common capital stock to the extent of \$70 per share per year. After 1962 dividends were paid sporadically on the Class A Common but in 1967 the payment of dividends ceased.

9. In 1969 there was pending against defendant a suit by his former law partners who were claiming that he had failed to inform them of receipt of a fee in kind consisting in an interest in a business of a client of the

firm and had failed to account to them for their share of that fee upon dissolution of the firm. Defendant was fearful that if the plaintiffs in that suit were successful they would execute upon his majority interest in Sans-Copy and would thereby obtain control of the corporation. Defendant proposed to K. Jay Holdsworth that he sell him four shares of the common capital stock of Sans-Copy reducing his ownership to 48 percent, but that as a condition of such sale, he would require that he be given an employment contract to provide the terms of his compensation and insure that he could not be discharged.

10. Defendant and plaintiff K. Jay Holdsworth agreed upon the terms of an employment agreement, the final draft of which provided, among other things, that defendant would be entitled to receive in exchange for services he was to render to Sans-Copy compensation on a graduated scale limited to approximately 25 percent of the gross receipts of Sans-Copy but not to exceed $24,000 per year for part-time work. Said form of agreement also provided that payment of dividends of not less than $70 per share per year on the Non-voting Class A Common Stock had priority over the payment of the salary.

11. After the form of the employment agreement was agreed upon, although the formal document was never signed, defendant caused dividends of $150 to be paid to plaintiffs each month through November, 1970, plus an additional dividend in the same amount during that month and increased his salary to $12,000 as provided by the terms of said form of agreement and transferred the four shares of his stock to plaintiff, K. Jay Holdsworth, for the consideration agreed upon.

12. In 1969, defendant was a member of a law firm known as Strong, Poelman & Fox. Sans-Copy paid that law firm the following amounts:

1966	$726.00
1967	477.00
1968	none
1969	961.00
1970	14,868.00

13. These amounts were not paid for legal services as shown on the statements but rather were paid to compensate his firm for time spent by defendant on the business of Sans-Copy for which defendant was also being paid by Sans-Copy.

14. In 1969 defendant caused Sans-Copy to lend to him the sum of $7,900 shown as loans to shareholders on the books and records of the corporation and the sum of $3,000 shown as an account receivable. In 1970 defendant caused Sans-Copy to increase its loans to him by $3,400 and in 1971, by $18,000. No promissory notes were ever issued to reflect said loans. No interest was ever charged or paid upon said loans and said loans were not shown upon the personal financial statements of defendant for the years 1969, 1970, 1971 or 1972 which defendant filed with banks for loan purposes.

15. In 1970 defendant caused the sum of $3,000 to be paid to his son as salary and paid to his wife's uncle approximately $6,800 for services claimed to have been performed for Sans-Copy. In addition, defendant took numerous deductions against the receipts of Sans-Copy for personal expenses, including payment to his lawyer for defense of the suit brought by his former partners, personal life insurance premiums and personal contributions.

16. The payments to Strong, Poelman and Fox, the loans to defendant and the misapplication of the funds of Sans-Copy were part of a device, scheme and artifice to defraud and were acts, practices and a course of dealing which operated and would operate as a fraud or deceit upon the plaintiffs.

17. In September, 1970, defendant successfully defended the suit brought by his partners on the ground of a release and in October defendant obtained the return from plaintiff K. Jay Holdsworth of the four shares of stock resulting in plaintiff having 52 percent of the outstanding voting common capital stock of Sans-Copy. No dividends were paid after November, 1970.

18. On January 12, 1971, defendant wrote plaintiff and Tanner a letter and deposited it in the United States mails stating:

> "Dear Jay and Paul:
>
> I was just advised by the accountants for Sans-Copy that we have declared in dividends for 1970 more funds than we had in surplus. In other words, we have declared some $200 or $300 out of capital.
>
> For obvious reasons, although nothing will be done about 1970, we will not be declaring any dividends for a month or two. I am sure you both understand the necessity for this action.
>
> Sincerely yours,
> /s/ Kline
> Kline D. Strong"

There was in fact a surplus for the year 1970. There was in fact no impairment of capital and defendant had met with his accountants between November 15, 1970 and January 12, 1971, the date of said letter, and had given them instructions as to how to treat payments to him, had discussed the tentative profit and loss statement as of November 15, 1970, which showed a deficit of in excess of $5,000 and had given them instructions to make adjustments to avoid showing a loss.

19. The statements contained in said letter of January 12, 1971, were false and were known by defendant to be false when made and were part of a

device, scheme and artifice to defraud and were acts, practices and a course of dealing which operated and would operate as a fraud or deceit upon the plaintiffs.

20. During 1971 defendant continued to pay personal expenses with funds of Sans-Copy and in addition caused to be paid to or for Utah Law Research Institute, a non-profit corporation of which defendant was the organizer and Executive Director, the sum of $29,900. These payments were not discussed with or approved by plaintiff K. Jay Holdsworth or Paul Tanner, who with defendant constituted the Board of Directors of Sans-Copy.

21. In 1971 defendant took from the funds of Sans-Copy $4,570 to make restitution to the profit sharing plan of his law firm, in exchange for which no legal services or other services of any nature were rendered for Sans-Copy, and defendant caused the same to be deducted on the books and records of Sans-Copy as legal and accounting services.

22. Said payments to Utah Law Research Institute and to defendant's law firm of Sans-Copy were part of a device, scheme and artifice to defraud and were acts, practices and a course of dealing which operated and would operate as a fraud or deceit upon the plaintiffs.

23. Although no dividends were paid during the year 1971, the personal net worth of defendant increased $262,000 according to statements filed September, 1970 and December 31, 1971, which, after adjustments claimed by defendant, showed an increase in his net worth of $112,000 during which time his reported income was $40,000.

24. On January 19, 1972, defendant stated to plaintiff K. Jay Holdsworth that Sans-Copy could not pay dividends and would not be able to pay dividends in the future and that he was satisfied that it would not pay

dividends in the future.

25. On January 21 defendant wrote a letter to plaintiff K. Jay Holdsworth and posted the same in the United States mails confirming said conversation and stating in part that:

> "1. If possible, I would like to acquire the common stock now at $300.
>
> "2. I will pay you for your entire interest in all of the preferred stock the same price as I work out with Paul and we will work out together what to do about the life estates respectively at that time. As I have indicated to you previously, I doubt that there will be any dividends in the future so perhaps the trustees will not be reluctant at that time to part with the life estate interest.
>
> "3. May I suggest that we close this transaction with respect to the preferred stock when the ranch is sold (since you will not need to show the preferred stock position on bank statements thereafter) but not later than December 31, 1972. If at that time you still feel it would be an advantage to show the preferred stock on your financial statement—assuming the ranch hasn't been sold in the meantime—I will be willing to consider an extension but it seems to me by that time Continental Bank must realize the preferred stock cannot be worth a great deal if it has not received a dividend in two years."

(Plaintiffs had theretofore transferred their Class A Common to Continental Bank under term trusts for the benefit of their children.)

26. Plaintiff K. Jay Holdsworth discussed his conversation with defendant and this letter with his wife, plaintiff Dona S. Holdsworth, and in reliance upon the representations made by defendant and their effect upon

the apparent value of their shares, were induced to and did sell their stock to defendant.

27. The representations made on January 19, 1972, and those contained in the letter of January 21, 1972, were false and were known by defendant to be false and were made by defendant as a part of device, scheme and artifice to defraud plaintiffs by inducing the plaintiffs to sell their stock and were acts, practices and a course of dealing which operated as a fraud or deceit upon the plaintiffs.

28. Plaintiffs did not learn of the falsity of the representations made by defendant until May 9, 1973, and on May 17, 1973, rescinded said sale and demanded the return of said shares and the reversions in the Class A Common and tendered return of the consideration of such sale.

29. Although plaintiff K. Jay Holdsworth was a Director and Secretary of Sans-Copy at the time plaintiffs agreed to sell their stock to defendant and made no demand to examine the books and records of Sans-Copy before selling his stock, his failure to do so was excusable under the facts and circumstances of this particular case and in view of the relationship of the parties. They were best of friends. They were engaged in another business, a ranch, which was supervised by plaintiff K. Jay Holdsworth as to which plaintiff K. Jay Holdsworth kept defendant fully informed of material developments and they were associated in their church and in bar activities and in publications.

30. The books and records of Sans-Copy were of such a nature that they did not reflect the true financial condition of the company or its ability to pay dividends. They were incomplete. They were adjusted and revised by defendant from time to time. They did not contain detail or description sufficient to enable a person examining

them to learn of the falsity of defendant's representations.

31. Defendant knew at all times he made representations concerning dividends that the books and records of the corporation did not reflect the actual ability of the corporation to pay dividends and knew that the corporation could pay dividends and would pay dividends but for defendant's misappropriations of the assets of the corporation and but for defendant's scheme to obtain plaintiffs' shares of stock in Sans-Copy.

32. Defendant had a present intention to defraud plaintiffs when he made the representations concerning the inability of Sans-Copy to pay dividends and lack of prospects for dividends being paid.

33. The evidence is clear and convincing that false representations were made concerning present existing material facts which representations defendant knew to be false and which representations were made for the purpose of inducing the plaintiffs to sell their stock and that the plaintiffs did sell their stock, acting reasonably under the circumstances and in ignorance of the falsity of said representations and that the plaintiffs in fact relied upon said representations and were thereby induced to sell their stock.

34. Defendant directly and indirectly, by the use of means and instrumentalities of interstate commerce and of the mails used and employed in connection with the purchase of said shares and the reversion in said shares manipulative and deceptive devices and contrivances in contravention of the rules and regulations of the Securities Exchange Commission of the United States promulgated pursuant to authority vested in said Commission by the Securities Exchange Act of 1934.

35. Defendant directly and indirectly, by the use of means and instrumentalities of interstate commerce and

of the mails, used and employed in connection with the purchase of said shares and the reversion of said shares devices, schemes and artifices to defraud as above set forth and made untrue statements of material facts as above set forth and omitted to state material facts necessary in order to make statements made, in the light of the circumstances under which they were made, not misleading, including:

A. That from 1961 through 1972 the gross receipts of Sans-Copy increased significantly each year:

For year ended 11-30-61	$13,030.88
For year ended 11-30-62	19,932.06
For year ended 11-30-63	19,095.43
For year ended 11-30-64	24,154.57
For year ended 11-30-65	$28,102.07
For year ended 11-30-66	28,730.60
For year ended 11-30-67	36,607.05
For year ended 11-30-68	51,565.28
For year ended 11-30-69	59,656.09
For year ended 11-30-70	75,385.48
For year ended 11-30-71	83,016.35
For year ended 11-30-72	96,857.59

B. That the gross receipts of Sans-Copy were more than sufficient to pay all legitimate expenses and to pay dividends at the level paid in the past or at higher levels but for defendant's diversions of the funds of Sans-Copy to himself or for his benefit.

C. That defendant did not consider the 1969 agreement effective and had not complied with its terms but instead had increased his compensation contrary to the terms of said form of agreement by means of payments to his law firm, personal loans, payment of personal expenses, and payments to or for a charity of which he was the organizer and executive director.

D. That defendant's termination of dividends in 1970 was for the purpose of inducing plaintiffs to believe that Sans-Copy was unable to pay dividends.

E. That between September, 1970 and December 31, 1971 defendant's net worth increased by at least $112,000 when his total income from all sources was $40,000.

F. That defendant did not consider the loans made by him to himself of the funds of Sans-Copy his obligation to repay.

36. Defendant directly and indirectly, by the use of means and instrumentalities of interstate commerce and of the mails in connection with the purchase of said shares and the reversion in said shares engaged in acts, practices and courses of business which operated as a fraud or deceit upon the plaintiffs as above set forth and, in addition, appropriated the assets of the corporation to his own use, caused false entries to be made in the books and records of the corporation, Sans-Copy, in such a way as to make it appear that the shares of stock of said corporation were of little value and subsequent to 1969, defendant systematically and totally excluded plaintiffs from any information about the true financial and economic condition of Sans-Copy by not holding Shareholders or Directors meetings, by not supplying to plaintiffs any copies of tax returns or other financial reports, by not consulting with plaintiffs on any major business decisions of Sans-Copy and by otherwise failing to disclose material facts about Sans-Copy.

From the foregoing Findings of Fact the court now draws the following

CONCLUSIONS OF LAW

1. This court has jurisdiction of the subject matter of this action and of the person of the defendant.

2. Defendant knowingly and intentionally made false and fraudulent misrepresentations of present existing material facts concerning the shares of stock of Sans-Copy for the purpose of inducing plaintiffs to sell their shares and reversions in their shares to him.

3. Plaintiffs sold their shares and the reversions in their shares in reliance upon said misrepresentations.

4. Plaintiffs acted reasonably under the circumstances of this case and the relationship of the parties and in ignorance of the falsity of said misrepresentations.

5. Defendant directly and indirectly, by the use of means and instrumentalities of interstate commerce and of the mails used and employed in connection with the purchase of said shares and the reversion in said shares manipulative and deceptive devices and contrivances in contravention of the rules and regulations of the Securities Exchange Commission of the United States promulgated pursuant to authority vested in said Commission by the Securities Exchange Act of 1934 and employed devices, schemes and artifices to defraud and made untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading and engaged in acts, practices and courses of business which operated as a fraud or deceit upon the plaintiffs.

6. Plaintiffs are entitled to restitution of their shares and the reversion in their shares.

7. Plaintiffs are entitled to a Decree directing the defendant forthwith to deliver said shares and said reversions to plaintiffs and cause the transfer thereof to be made upon the stock books and records of Sans-Copy, namely:

To plaintiff K. Jay Holdsworth, 11 shares of the Common Capital Stock and the reversion in 15 shares of the Non-voting Class A Common Capital Stock; and

To plaintiff Dona S. Holdsworth, 11 shares of the Common Capital Stock and the reversion in 15 shares of the Non-voting Class A Common Capital Stock.

8. Plaintiffs are entitled to their costs.

9. A Decree should be entered accordingly.

Dated this 21 day of December, 1974.

/S/____________________
Willis W. Ritter, Chief Judge

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF UTAH
CENTRAL DIVISION

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Plaintiffs, DECREE
vs.
KLINE D. STRONG, No. C 190-73
Defendant.

The above-entitled cause having come on regularly for trial on November 25, 1974, before the Honorable Willis W. Ritter, without a jury, Harold G. Christensen and R. Brent Stephens for Worsley, Snow & Christensen for the plaintiffs and Clifford L. Ashton and Brent Stevenson of Van Cott, Bagley, Cornwall and McCarthy for the defendant, and the court having heard testimony of witnesses and received exhibits and heard argument of counsel and having made and entered its Findings of Fact and Conclusions of Law, now, therefore, it is

ORDERED, ADJUDGED AND DECREED that defendant be and he hereby is directed to return to plaintiff K. Jay Holdsworth 11 shares of the Common Capital stock of Sans-Copy and the reversion in 15 shares of the Non-voting Class A. Common capital stock of Sans-Copy and to plaintiff Dona S. Holdsworth 11 shares of the Common Capital stock of Sans-Copy and the reversion in 15 shares of the Non-voting Class A Common capital stock of Sans-Copy, sold by plaintiffs to defendant on March 29, 1972, and to cause the transfer thereof to be made upon the stock books and records of Sans-Copy and that plaintiffs be awarded their costs.

Dated this 21 day of December, 1974.

By /S/__________________
Willis W. Ritter, Chief Judge

APPENDIX C

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Plaintiffs-Appellees,

v. No. 75-1144

KLINE D. STRONG,
Defendant-Appellant.

APPEAL FROM THE UNITED STATES
DISTRICT COURT
FOR THE DISTRICT OF UTAH
(D. C. No. C-190-73)

Clifford L. Ashton (Brent M. Stevenson, on the brief), Salt Lake City, Utah, for Defendant-Appellant.

Harold G. Christensen, Salt Lake City, Utah, for Plaintiffs-Appellees.

Before HILL, HOLLOWAY and DOYLE, United States Circuit Judges.

HILL, Circuit Judge.

Appellant comes to this Court seeking reversal of the trial court's judgment rescinding a stock sale by appellees to appellant. Rescission was granted because of violations of Section 10b of the Securities Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, and because of a common law fraud.

In 1959 appellant Kline D. Strong, appellee K. Jay Holdsworth[1] and Paul Tanner formed a corporation

[1]When referring to appellee K. Jay Holdsworth, we will use only the name Holdsworth. Reference to Holdsworth and his wife will be made by use of the term "appellees".

named Sans-Copy. Initially 60 shares of common capital stock were issued. The 60 shares eventually were divided as follows: 20 shares to appellant and his wife; 20 shares to Holdsworth and his wife (appellees); and 20 shares to Tanner and his wife. The sum of $300 was paid for each block of 20 shares. The purpose of the corporation was to develop, manufacture and market timekeeping systems for law offices.

Sans-Copy entered into an agreement with Reynolds & Reynolds Company in 1959; Reynolds & Reynolds was granted the exclusive rights to manufacture and market Sans-Copy timekeeping systems except that marketing in Utah and Arizona was to be done by Sans-Copy itself. Sans-Copy was to receive a royalty on all sales, varying from 30% downward. The agreement required appellant to promote Sans-Copy systems at bar associations' meetings.

Also in 1959, the ordinary common stock of the corporation was increased to 100 shares. Following allocation of the new shares, stock holdings were as follows: appellant and his wife, 52 shares; the appellees, 22 shares; the Tanners, 22 shares; and Robert Shirley (an employee of Tanner), 4 shares. From 1959 to 1962, no dividends were paid to the holders of this ordinary common stock, in fact, no dividends have ever been paid to holders of this stock.

In 1962, a new type of stock was issued by Sans-Copy. This non-voting Class A common stock provided a means to compensate Holdsworth and Tanner who were not engaged in the corporation's work. The Class A stock was given a non-cumulative dividend preference over the ordinary common stock to the extent of $70 per share. The appellees and the Tanners received 30 shares of the new stock per couple; $300 was given for 30 shares. Sans-Copy's board of directors approved a resolution that appellant ". . . should be compensated for his services

commensurate with the value of his services to the Corporation in such amount or amounts as the Board of Directors may from time to time determine." Dividends were paid sporadically on this Class A stock until 1970.[2]

On January 12, 1971, appellant wrote Holdsworth and Tanner the following letter:

> I was just advised by the accountants for Sans-Copy that we have declared in dividends for 1970 more funds than we had in surplus. In other words, we have declared some $200 or $300 out of capital.
>
> For obvious reasons, although nothing will be done about 1970, we will not be declaring any dividends for a month or two. I am sure you both understand the necessity for this action.

On January 19, 1972, Holdsworth and appellant were in Holdsworth's office discussing problems concerning a ranch they owned which was supervised by Holdsworth. Appellant told Holdsworth he desired to acquire all the Sans-Copy stock held by the Holdsworth family for $1500.[3] Holdsworth testified that appellant said:

> . . . the corporation has not paid dividends the last year because it couldn't, it didn't have any income, and he was satisfied the corporation would never pay any dividends that would in any way help me with any of the cash requirements that I had . . . .

[2]To the extent this statement contradicts the trial court's finding of fact (#8), we hold that finding to be clearly erroneous. An exhibit submitted by appellees discloses the following amounts of dividends received: 1962, $354.72; 1963, $805.36; 1964, $734.94; 1965, $1576.23; 1966, $1549.32; 1967, $1233.83; 1968, $243.76; 1969, $600.00; 1970 $1800.00. These total $8898.16.

[3]Appellees' Class A stock had been contributed to ten-year term trusts set up for their children. Appellees retained the reversionary interests.

This oral proposal was followed by a letter from appellant to Holdsworth on January 21, 1970. In that letter appellant mentioned he had made a purchase offer to Tanner. In discussing certain details of the transaction, appellant wrote, "As I have indicated to you previously, I doubt that there will be any dividends in the future . . .". The Tanners sold their stock. Appellant paid $500 for the 22 shares of Sans-Copy ordinary common stock and Sans-Copy redeemed the Tanners' 30 shares of Class A stock for $1000.

The appellees sold all interests they had to sell in their stock in the first part of 1974 [*sic*].[4] The Strongs agreed to release and indemnify Holdsworth from any and all liabilities that might arise from his having been a director, shareholder, secretary and treasurer of Sans-Copy and having been a trustee for Sans-Copy's employee profit sharing plan. A release was also secured from all claims for reimbursement for salaries and expenses paid by Sans-Copy to Claude Clark (Mrs. Strong's uncle) when he worked on the ranch owned by Holdsworth and appellant.

On May 17, 1973, the appellees made a formal demand on appellant that the sale of their Sans-Copy stock be rescinded. Appellant rejected that demand. On May 31, 1973, appellees commenced suit against appellant. Their complaint alleged that in connection with the Sans-Copy stock purchase (1) appellant made the following misrepresentations of material facts: (a) it would be unlikely that Sans-Copy would pay any dividends in the future, (b) Sans-Copy was unable to pay any dividends on the preferred stock, and (c) Sans-Copy would be unable to pay any dividends on the preferred stock in the future; (2) appellant omitted to state certain material facts necessary to make statements not

[4]The sale included 22 shares of ordinary common stock and the reversionary interests in 30 shares of Class A stock.

misleading, including (a) Sans-Copy's gross receipts for the fiscal year ending November 30, 1971, were in excess of $96,000, (b) deductions and expenses taken against gross receipts for 1971 and prior years were unnecessary, unreasonable and excessive, (c) many of these deductions constituted payments to or for appellant or his relatives, (d) $1500 was not a fair price in view of the actual earnings of the corporation, its history of growth and its future prospects, and the stock's market value, and (e) appellant had personally borrowed substantial funds from the corporation with $30,000 remaining unpaid on November 30, 1971; (3) appellant employed devices, schemes or artifices to defraud and engaged in acts, practices and a course of business which operated as a fraud or deceit upon appellees; and (4) appellant breached his fiduciary responsibility to appellees and violated the special relationship of trust and confidence which existed.

Following a trial to the court, a judgment was entered ordering appellant to return the ordinary common stock and the reversion interest in the Class A stock to appellees. Findings of Fact and Conclusions of Law were entered.

Numerous issues have been raised on appeal. Because two issues are dispositive—due diligence and the necessity of damages—we consider only these two matters.

Appellant contends that the judgment based on federal securities law must be reversed because appellees did not exercise due diligence in selling their stock. Appellees counter this argument in two ways: (1) due diligence is not a defense in a rescission action under Rule 10b-5 based upon affirmative misrepresentations; and (2) appellees did exercise due diligence.

This Court has often indicated that a plaintiff must

act with due diligence in the transaction relevant to the 10b-5 claim. Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), *cert. denied,* 414 U.S. 874; Mitchell v. Texas Gulf Sulphur Co., 446 F. 2d 90 (10th Cir. 1971), *cert. denied,* 404 U.S. 1004 and 405 U.S. 918 (1972); Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970). In requiring due diligence on plaintiff's part, this Circuit has not been alone. *See* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied,* 402 U.S. 988 (1971); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Kohler v. Kohler, 319 F.2d 634 (7th Cir. 1963); Hartnett v. Ryan Homes, Inc., 360 F. Supp. 878 (W.D. Pa. 1973), *aff'd* 496 F.2d 832 (3rd Cir. 1974). One commentator supporting this requirement stated:

> It is noteworthy that the circuits which have most clearly charged defendant with constructive knowledge or diligence [the 8th, 9th and 10th . . .] are, by and large, the same courts that have similarly charged plaintiff. There is a logic and a balance in this. A high standard of conduct for defendant justifies a high standard for plaintiff. Stated a little differently, the price plaintiff pays for being relieved of the burden of proving defendant's intent or actual knowledge, is that plaintiff himself must show some diligence.

2 Bromberg, Securities Law: Fraud Sec. 10b-5, § 8.4(652) (1974).

Appellees point to Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), as authority for the proposition that due diligence is not an element of this 10b-5 action. The Court in *Affiliated Ute* discussed the requisite proof of reliance in the following manner:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is

> necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision [citations omitted]. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

The "constructive reliance" principle of *Affiliated Ute* is not, however, applicable to the instant situation which involves, to a large extent, misrepresentations. *See* Titan Group, Inc. v. Faggen, 513 F.2d 234 (2d Cir. 1975); 5 Jacobs, The Impact of Rule 10b-5, § 64.01 (1974). Rather, we believe that "subjective reliance" as discussed by Jacobs in the aforementioned treatise is applicable and with it comes our traditional consideration in this Circuit of due diligence. Furthermore, due diligence must be shown in this case, although the prohibited acts primarily were found to be done intentionally. *See* Clement A. Stevens & Co. v. McAlpine, *supra.*

In the instant matter, appellees exercised no diligence. They have sought to excuse this failure—and succeeded in doing so in the trial court—by relying on the relationship of the parties and the condition of the Sans-Copy records. The trial court made the following findings.

> 29. Although plaintiff K. Jay Holdsworth was a Director and Secretary of Sans-Copy at the time plaintiffs agreed to sell their stock to defendant and made no demand to examine the books and records of Sans-Copy before selling his stock, his failure to do so was excusable under the facts and circumstances of this particular case and in view of the relationship of the parties. They were best of friends. They were engaged in another business, a ranch, which was supervised by plaintiff K. Jay Holdsworth as to which plaintiff K. Jay Holdsworth kept defendant fully informed of material developments and they were associated in their church and in bar activities and in publications.

> 30. The books and records of Sans-Copy were of such a nature that they did not reflect the true financial condition of the company or its ability to pay dividends. They were incomplete. They were adjusted and revised by defendant from time to time. They did not contain detail or description sufficient to enable a person examining them to learn of the falsity of defendant's representations.

Appellees make a detailed assault on appellant's handling of the corporation's monies. Appellees state:

> It would have been impossible without an audit to learn anything concerning the actual financial condition of this company. All that would have been shown by an examination of the records Strong claims were kept was that all income of the company was systematically consumed by "expenses". There would have been no way without looking at each expenditure to determine whether the expenditure was lawful or reasonable or, rather, was an embezzlement by Strong.

We agree that if in the exercise of due diligence appellees could not have discovered this "consumption" of income they had no duty to examine the corporation's books. In other words, if the books did not reflect the course of conduct alleged, we could not require appellees to perform a useless act. Rochez Bros., Inc. v. Rhoades, 491 F.2d 402 (3rd Cir. 1974). Our examination of Plaintiff's Exhibit 24, part of the books appellees could have inspected, discloses many expenditures to appellant, members of his family, his law firm, and a research bureau with which appellant was involved.[6]

---

[6] [There is no footnote 5] The relevant findings of fact as to the expenses are included below.

12. In 1969, defendant was a member of a law firm known as Strong, Poelman & Fox. Sans-Copy paid that law firm the following amounts:

1966	$726.00	1968	none	1970	$14,868.00
1967	$477.00	1969	$961.00		

Thus, we believe the trial court was clearly erroneous in determining the records did not contain enough detail to enable a person examining them to learn of the falsity of appellant's representations. These expenditures appear clearly on the records and would certainly incite a person with reasonable business prudence to make further inquiry as to the authorization of such expenditures.

---

13. These amounts were not paid for legal services as shown on the statements but rather were paid to compensate his firm for time spent by defendant on the business of Sans-Copy for which defendant was also being paid by Sans-Copy.

14. In 1969 defendant caused Sans-Copy to lend to him the sum of $7,900 shown as loans to shareholders on the books and records of the corporation and the sum of $3,000 shown as an account receivable. In 1970 defendant caused Sans-Copy to increase its loans to him by $3,400 and in 1971, by $18,000. No promissory notes were ever issued to reflect said loans. No interest was ever charged or paid upon said loans and said loans were not shown upon the personal financial statements of defendant for the years 1969, 1970, 1971 or 1972 which defendant filed with banks for loan purposes.

15. In 1970 defendant caused the sum of $3,000 to be paid to his son as salary and paid to his wife's uncle approximately $6,800 for services claimed to have been performed for Sans-Copy. In addition, defendant took numerous deductions against the receipts of Sans-Copy for personal expenses, including payment to his lawyer for defense of the suit brought by his former partners, personal life insurance premiums and personal contributions.

16. The payments to Strong, Poelman and Fox, the loans to defendant and the misapplication of the funds of Sans-Copy were part of a device, scheme and artifice to defraud and were acts, practices and a course of dealing which operated and would operate as a fraud or deceit upon the plaintiffs.

20. During 1971 defendant continued to pay personal expenses with funds of Sans-Copy and in addition caused to be paid to or for Utah Law Research Institute, a non-profit corporation of which defendant was the organizer and Executive Director, the sum of $29,900. These payments were not discussed with or approved by plaintiff K. Jay Holdsworth or Paul Tanner, who with defendant constituted the Board of Directors of Sans-Copy.

21. In 1971 defendant took from the funds of Sans-Copy $4,570 to make restitution to the profit sharing plan of his law firm, in exchange for which no legal services or other services of any nature were rendered for Sans-Copy, and defendant caused the same to be deducted on the books and records of Sans-Copy as legal and accounting services.

Holdsworth is a sophisticated investor. He has a master's degree in accounting and, as a practicing lawyer, has done considerable tax and estate planning work. It is true he and appellant were friends which might somewhat diminish his duty of inquiry; however, Holdsworth was also secretary and director of this very small corporation. As the Eighth Circuit indicated in Myzel v. Fields, 386 F.2d 718 (1967), a director is ". . . chargeable with a degree of notice of those facts which the corporate books . . . would fairly disclose." In fact, we believe *Myzel* is very close to our problem here. In one of four actions reported in *Myzel*, a director placed total reliance on information of an insider in selling his stock. The court expressed its great difficulty in finding sufficient proof to carry all the cases to the jury but found sufficient proof. In considering "reliance", the court depended heavily on representations made by the insider to the seller concerning matters not available in the corporate records. The court said, "If Vertelney had been misled solely by Phil Myzel's statements or nondisclosures regarding the company's value, and on that basis alone had sold his stock, recovery would be denied." In the instant matter the representations dealt solely with the ability of the corporation to pay dividends; consequently, the determinative factor in *Myzel* is missing in the instant case.

In Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971), the court discussed the element of diligence and stated:

> . . . solutions in this area are not obtained by application of abstract rules, but rather must be formulated from the particular facts and circumstances of each case within the context of the principles and policy of the statute and the rule.
>
> . . . .
>
> . . . the plaintiff's sophistication, expertise and business acumen in the financial community, his

> access to information and opportunity to detect the fraud are all relevant considerations in determining the exercise of reasonable diligence.

Applying these factors to the facts as determined by the court, we believe the trial court was clearly in error in determining appellees had exercised due diligence in this transaction. We recognize the rarity in which due diligence has been allowed as a defense in intentional conduct siuations; however, the facts of this case require its application. The failure of appelles to investigate at all cannot be excused by the relationship of the parties. The sale here involved stock in a small corporation where value was not readily ascertainable. Holdsworth was a sophisticated investor. He had served as an officer and director of this corporation for years. He had apparently acquiesced in and certainly was aware of the informal manner in which corporate affairs were handled. Yet, he made no investigation when appellant offered to buy his stock. Holdsworth's failure to exercise any prudence cannot be excused; this non-action does not approach the due diligence requirement consistently articulated by this Court.

Having determined that due diligence, an essential element of this 10b-5 action, was not proven, we need not consider other matters presented concerning the 10b-5 judgment. That judgment is reversed. We must now consider if the judgment on the common law fraud action can be sustained.

Appellant contends detriment or injury is an essential element of a common law fraud action in Utah and further urges appelees did not show any injury or detriment. Thus, appellant argues this cause of action also fails.

Appellant presents numerous cases which state directly that damages or detriment is an essential element of fraud and deceit in Utah. Justheim Petroleum

Co. v. Hammond, 227 F.2d 629 (10th Cir. 1955); Dilworth v. Lauritzen, 424 P.2d 136 (Utah 1967); Child v. Hayward, 400 P.2d 758 (Utah 1965); Rummell v. Bailey, 320 P.2d 653 (Utah 1958); Kinnear v. Prows, 16 P.2d 1094 (Utah 1932); Guaranty Mortgage Co. v. Flint, 240 P. 175 (Utah 1925). Appellees would distinguish these cases on numerous factual differences and especially the fact that damages is the relief sought in many of them instead of rescission. Appellees cite treatise authority for the proposition that actual damage is not necessary when rescission is the remedy sought for fraudulent conduct.

Appellant's cases clearly state that damages or detriment is an *essential element* of fraud and deceit and do not make any mention of the elimination of this element when only rescission is sought. The Utah court has indicated that "fraud in the air" is not sufficient for a cause of action. Rummell v. Bailey, *supra.*

> The essential elements of fraud are, as a rule, not controlled by the fact that the action is at law or in equity or by whether fraud is asserted as a cause of action or as a defense, although equity will grant relief in some instances where it would ordinarily be refused at law, as, for example, where a scienter is not present or there has been no pecuniary damage.

37 C.J.S. *Fraud* § 4 (1943). *See* 37 Am. Jur. 2d *Fraud and Deceit* § § 283, 284 (1968). Appellees do not cite and we have not located any Utah case showing a deviation from the essential elements listed in the cases cited above; consequently, a showing of injury or detriment is necessary for a common law fraud action in Utah.

Having determined that detriment or injury is an essential element, we must determine if the evidence of detriment was sufficient. Appellant contends the appellees actually received more for their stock than it was worth at the time of sale. Appellees point to the oral finding of the trial court that Holdsworth was deceived *to*

his detriment and the formal finding which states that the representations "operated as a fraud and deceit upon the plaintiffs." Appellees contend pecuniary injury or damages was adequately demonstrated. They argue a court of equity should not allow appellant now to say the stock had only nominal value when he caused the low valuation by his inequitable conduct. Appellees again point to the evidence that appellant failed to properly handle corporate assets and appropriated them to his own benefit. Further, appellees enumerate various rights which have some value that are associated with stock ownership.

We recognize that with the stock appellees gave up valuable rights which stockholders normally possess. The issue, however, is whether these valuable rights were adequately compensated for by the appellant. Appellees had the burden of proving detriment. This is not a case where property was given up in exchange for misrepresented property. Rather, appellees needed to show they were not fairly compensated for the property they sold. That proof was lacking.

The only other sale of Sans-Copy stock within a close period of time to the sale by appellees was by the Tanners for the same consideration given the appellees. This is not a case where a turn-around profit on the stock because of non-disclosed information (obtainable only outside corporate records) was shown. Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965), *cert. denied,* 382 U.S. 879. Appellees argue several methods of stock valuation to this Court: book value (appellees say it is modest here only because of appellant's machinations); per share earnings and the rate at which those earnings are growing (appellees state it is limited because of appellant's diversions); a rate of return basis of 5%, establishing a $1400 per share value on the Class A common stock with its $70 per share preference. No argument is made that these methods were utilized by the

trial court or urged on the trial court. Furthermore, no expert witness testified for appellant as to proper valuation methods of this stock in a small corporation. Rather, appellees seek to diminish testimony of appellant's expert witness, which we recognize is not controlling on us. On the record, we do not believe appellees established any detriment as required in a cause of action for fraud in Utah; consequently, the judgment under that cause of action must also be reversed.

DOYLE, Circuit Judge, Dissenting.

I respectfully dissent.

First, it is to be noted that the majority opinion takes as true the fact that the defendant Strong converted the funds of Sans-Copy to his own use and also misrepresented and omitted to make material disclosure of the business prospects to the plaintiff in connection with his purchase of the stock. In view of this, it is surprising that the court would readily rule in favor of defendant.

It is said that a condition of a 10b-5 action is that the purchaser of the stock shall exercise due diligence. Three Tenth Circuit cases are cited for this, but when they are studied they do not give strong support to the result reached. Thus, in Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970), the crucial issue was materiality of the misrepresented facts in connection with the sale of fractional interests in oil leases plus the necessity for purchaser reliance on these facts. On the other hand, the due diligence reference is to the seller in assuring the accuracy of facts he represented. See 429 F.2d at 356. There is no discussion of the plaintiff's diligence. At the same time, the court carefully pointed out that the plaintiff-appellees should not be burdened with making an independent investigation to verify the accuracy of false representations.

Nor does Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), make any substantial contribution. There the question was whether a corporation had failed to make sufficiently prompt disclosure of a change in business conditions, whereby a mutual fund purchasing a large block of stock could recover. The court mentioned the due diligence requirement for a purchasing plaintiff, but the court does not rest its decision on that requirement. In holding for Douglas the court does not rely on the lack of diligence of the Fund. In that case also the two parties were on a more or less equal footing.

Mitchell v. Texas Gulf Sulphur, 446 F.2d 90 (10th Cir. 1971), also has a different fact situation. There Texas Gulf Sulphur had put out a press release April 13, 1964, disavowing the importance of a copper find in Canada. The release contained misrepresentations of material facts. A corrected release was put out April 16, 1964, which received widespread publicity. Five days after the correction the plaintiffs sold Texas Gulf Sulphur stock in reliance on the April 13 data. It was held that the failure of the plaintiffs to become aware of the corrected press release precluded them from recovering and this result is understandable. This was a correction and it is pretty hard for the person relying on the first press release to justify failure to become aware of the second one.

Also in the case at bar, we do not have the elements that were present in Texas Gulf Sulphur, namely, the need for limitation of liability and relatively little culpability of the alleged wrongdoer. Here we have a palpable fraud and direct profiting from the defrauder's own misrepresentations. Where, as in the case at bar, the misrepresentations were intentional, there seems little point in allowing the defendant to escape merely because the plaintiff was a negligent victim. The reason for this conclusion is that no legal relationship exists between intentional harm and contributory negligence. But even

if you apply due diligence as the standard in this case, the close relationship or trust and confidence between Holdsworth and Strong renders the negligence irrelevant. It is in a sense a quasi-fiduciary situation. See Bird v. Ferry, 497 F.2d 112 (5th Cir. 1974).

But even if the 10b-5 claim is ruled out there is no apparent reason for quashing the common law fraud based upon Utah law. In assessing this action by the majority we note that no credence was given to the factor of the district judge's knowledge of local law. See Binkley v. Manufacturers Life Ins. Co., 471 F.2d 889 (10th Cir. 1971), cert. denied, 414 U.S. 877 (1973). Also, there is no basis for denying that the plaintiff suffered injury. Actual damages in a money sense did not have to be shown since he was seeking a rescission. All that was needed was fraud together with an injury. Plaintiff was certainly injured considering that the corporation from which he had purchased stock as a result of fraudulent representations and non-disclosures has itself suffered and thus his interest has suffered from the misdeeds of the managing officer. This is sufficient to give equitable relief.

APPENDIX D

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

No. 75-1144

K. JAY HOLDSWORTH and DONA S. HOLDSWORTH, Plaintiffs-Appellees, vs. KLINE D. STRONG, Defendant-Appellant.	Appeal from the United States District Court for the District of Utah (D.C. No. C-190-73) (On rehearing en banc)

Submitted July 8, 1976

Edwin S. Kahn of Holland & Hart, Denver, Colorado (Clifford L. Ashton and Brent M. Stevenson of Van Cott, Bagley, Cornwall & McCarthy, Salt Lake City, Utah, on the brief), for Defendant-Appellant.

Harold G. Christensen of Worsley, Snow & Christensen, Salt Lake City, Utah, for Plaintiffs-Appellees.

Before HILL, SETH, HOLLOWAY, McWILLIAMS, BARRETT and DOYLE, Circuit Judges. LEWIS, Chief Judge, did not participate.

DOYLE, Circuit Judge.

Plaintiff-Appellees prevailed in an action for rescission of a sale of stock. Appellant Kline D. Strong was found to have made the sale by using false representations and fraudulent devices. The suit was brought pursuant to Section 10b of the Securities and

Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Recovery was also obtained on a parallel claim in common law fraud.

The Holdsworths, husband and wife, sold their shares of stock in a closely held corporation called Sans-Copy to Strong, who had owned the majority of the stock in this corporation. Strong persuaded them to sell the stock, generally representing that the company was unable and would be unable to pay dividends. In truth, the company was continuously increasing its volume and had demonstrated earning capability.

The cause was tried to the court as an equity case, the Holdsworths' demand for a jury trial having been denied. It required four days to complete. At the end of the trial the judge announced from the bench that there was clear evidence of fraud and that Mr. Strong had violated Rule 10b-5 as well as all of the elements of a common law fraud case under the law of Utah. He then set forth his findings in oral form. These were later incorporated in a formal set of findings of fact and conclusions of law which were signed December 21, 1974. Strong did not seek a new trial nor did he challenge the findings and conclusions in the trial court. Instead he appealed at once to this court.

Both Kline D. Strong and the appellee K. Jay Holdsworth are attorneys; Holdsworth is an accountant as well. Paul Tanner, who was also a part of the enterprise in question, was and is an accountant. The mentioned parties formed the subject corporation. Its purpose was to develop, manufacture and sell time-keeping systems for law offices. Originally there were 60 shares of common stock which were divided equally among the three incorporators and their wives. Each couple paid $300 for 20 shares. It was contemplated at the outset that all three would participate in the management of the corporation. It did not work out as planned, however; Mr. Strong ended up in complete

charge of the business. In its initial stages he performed research and other preliminary work developing the idea and introducing it to the legal profession. Essentially, it was a simple system for recording the time spent by lawyers working for clients.

In July 1959, Sans-Copy entered into an agreement with Reynolds and Reynolds granting to the latter the exclusive right to manufacture and market the system except in Utah. Under the agreement Sans-Copy was to receive a royalty of 30 percent on gross sales and Strong was to promote the time-keeping system at bar association conventions and meetings. It was as a result of this change of condition that the shares in the corporation were changed; Strong informed Holdsworth that since he was doing most of the work he believed that he should own a controlling interest. Holdsworth and Tanner agreed to this, and as a result Strong was given 52 shares of the 100 shares of the outstanding stock in the corporation.

The details of the Sans-Copy process is not of primary importance, but a brief description will help general understanding. It was and is a method for recording and keeping records of the time spent by a lawyer on a client's case. It furnishes a daily log as well as separate slips to be sorted for use in determining bills. The system was intended to provide an easy way for lawyers to keep time sheets and to prevent double or triple entry accounting.

Strong was being paid compensation for his efforts, and Holdsworth and Tanner were given some shares of newly created stock which provided for them to get a small dividend annually. These dividends were paid irregularly in the Class A common stock until 1970, at which time they were abruptly terminated.[1]

[1]The Holdsworths submitted an exhibit which showed the following dividend payments on the Class A common stock:

1962	$ 354.72	1966	$1549.32
1963	805.36	1967	1233.83
1964	734.94	1968	243.76
1965	1576.23	1969	600.00
		1970	1800.00

After 1962, there were neither board meetings nor financial statements furnished to Holdsworth and Tanner. Holdsworth did not participate in the management of the corporation and his knowledge was restricted to information furnished by Strong.

In 1971, Strong notified Holdsworth and Tanner that the company had invaded capital in issuing 1970 dividends. For that reason, they were told that no dividends would be forthcoming at that time.

Holdsworth and Strong also owned a ranch, and subsequently, in January 1972, during the course of a conversation between Strong and Holdsworth having to do with the ranch, Strong offered to buy the Holdsworth shares for $1500. Strong at that time represented to Holdsworth that the corporation would never pay dividends in the future. He repeated this oral statement in a letter to the Holdsworths a short time later. Based on that statement and others, the Holdsworths sold their shares for $1500 and a general release. In the same year, Holdsworth learned that Sans-Copy had realized a gross income exceeding $100,000 and his knowledge moved them on May 17, 1973, to give notice of rescission. When Strong rejected this attempt, they started the present suit on May 31, 1973. Their claims were based on the following material misrepresentations and omissions (summarized and paraphrased hereafter):

Strong's statement that it was unlikely that dividends would be paid in the future; that the corporation was unable to pay present or future dividends on the preferred shares; omission by Strong to state material facts necessary to render the statements

non-misleading; that at the end of the fiscal year ending November 30, 1971, Sans-Copy had gross receipts in excess of $96,000; gross receipts were increasing each year since 1969; Sans-Copy was a growing enterprise; deductions were unnecessarily excessive and improper and many of these were paid to Strong and his relatives; that Strong had borrowed from the corporation and not repaid the loans; furthermore, that the $1500 was an unfair price in light of the earnings of the corporation and its growth potential. It was also alleged that Strong had employed schemes and devices to defraud, had engaged in acts, practices and a course of business which had operated as a fraud and had breached his fiduciary responsibility to the Holdsworths, violating their special relationship of trust and confidence.

After a trial to the court, it was ordered that Strong return the common stock and the reversions in the Class A common stock to the Holdsworths.

THE TRIAL COURT'S FINDINGS

In the trial court's findings of fact and conclusions of law it was brought out that the Holdsworths and Strongs were close friends and that this had been an important element in their entering into the enterprise. The trial court also considered some of the excessive expenditures which had been made by Sans-Copy to Strong's law firm. Excessive loans made to Strong from Sans-Copy funds were detailed. Amounts paid to Strong's immediate family and payment of personal expenses to Strong from the funds of Sans-Copy without approval or authorization of Holdsworth or Tanner were pointed out as was payment of funds to Strong and his law firm in 1971 charged as attorney's fees but for which no legal services had been rendered.

The court also found that:

In 1970-71, the net worth of Strong was shown to

have increased substantially; the defendant had misrepresented that there had been an invasion of capital in the payment of dividends in 1970.

There was in fact a surplus for that year. During 1971, Strong had diverted a large sum of money from Sans-Copy to a non-profit corporation, Utah Law Research Institute, of which he was the organizer and executive director.

In 1971, defendant diverted funds from Sans-Copy to make restitution to the profit sharing plan of his law firm; no legal services were rendered to Sans-Copy for this payment of $4570.

During the year 1971, the net worth of appellant Kline Strong increased $262,000 which, after adjustments claimed by appellant, showed an increase of $112,000.

Notwithstanding the foregoing, the trial court found, appellant maintained that Sans-Copy was unable to pay dividends and would be unable to pay dividends in the future. Representations in Strong's letter to Holdsworth offering to buy him out were knowingly false statements relied on by the Holdsworths in accepting the offer to buy their stock.

The sale of the stock without examination of the books was held to be excusable in view of the friendly relationship of the parties, being engaged in the ranching business together as well as Sans-Copy. The books and records, according to the further finding of the court, failed to accurately reflect the condition of the company; they were incomplete and had been adjusted and revised by the defendant. So examination would not have been helpful in learning the truth.

The court determined that the evidence was clear and convincing that false representations were made by

defendant concerning the present facts, which representations the defendant knew to be false and which representations were made for the purpose of inducing the plaintiffs to sell their stock and that the plaintiffs did sell their stock acting in reliance upon the representations made and in the belief that the representations were true.

The court's conclusions of law emphasized that the defendant knowingly and intentionally made false representations of present existing facts concerning the shares of stock of Sans-Copy for the purpose of inducing plaintiffs to sell their shares, and the plaintiffs sold their shares in reliance on the representations and that they acted reasonably under the circumstances of the case and the relationship of the parties and in ignorance of the falsity of the representations. The court concluded that there had been a violation of Section 10b and Rule 10b-5 of the Securities and Exchange Act of 1934, all of which entitled the plaintiffs to restitution.

APPELLANT'S CONTENTIONS

On appeal Strong contends:

First, that the judgment based on Rule 10b-5 should be reversed because of the failure of the Holdsworths to exercise due diligence in selling their stock.

Second, that the judgment based on Rule 10b-5 together with the common law of fraud should be reversed because the Holdsworths did not suffer damage.

Third, that the judgment based upon common law fraud should be reversed because the Holdsworths were not justified in relying on Strong's statement.

Fourth, that the misrepresentations lacked materiality.

Inasmuch as the defendant does not challenge the general sufficiency of the evidence but rather bases his demands for reversal on alleged trial error, we address our comments to the specifics but, at the same time, note in passing that substantial evidence of intentional fraud and deceit is present.

I
THE DUE DILIGENCE ISSUE

Strong's principal contention is that as a corporate insider, an attorney and accountant, Holdsworth was duty-bound to ascertain the corporation's financial status for himself prior to selling his stock. Instead, Strong asserts, the Holdsworths made no effort to investigate Sans-Copy's finances, notwithstanding that they had access to the corporate books and records. By strongly contending that Holdsworth should have diligently ascertained the truth, he seeks to shift the focus from his own intentional misrepresentations and omissions, which are not seriously disputed, to emphasis on alleged failures on the part of the Holdsworths to learn the truth.

The primary issue is, then, whether in an intentional fraud case such as the instant one, the victim is barred from relief if he does not exercise due care to avoid being deceived, due diligence being generally defined as the requirement that an insider "must fulfill a duty of due care in seeking to ascertain for himself the facts relevant to a transaction" before he may claim reliance on a material misrepresentation or omission. Cf. Rochez Bros., Inc. v. Rhoades, 491 F. 2d 402, 409 (3d Cir. 1974), citing cases.

In Clement A. Evans & Co. v. McAlpine, 434 F. 2d 100 (5th Cir. 1970), cert. denied, 402 U.S. 988 (1971) at 104, the court defined due diligence in the course of the following statement:

> We feel that step one of our test properly reflects these considerations as the objective standard of a reasonable investor exercising due care in light of all facts effectively imposes a duty of reasonable investigation . . . .

See also Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F. 2d 275, 282 (2d Cir. 1975) and City National Bank of Fort Smith, Ark. v. Vanderboom, 422 F. 2d 221, 230 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970). Where the due diligence standard is applied it requires insiders or sophisticated investors who have access to information to take positive steps to ascertain the facts for themselves.

But it is important to note that the circuits which have imposed the due diligence requirement have done so in the context of the application to the defendant of a negligence standard. Examples of circuits which have ruled that proof of negligent misrepresentations was sufficient to constitute a violation of 10b-5 are: White v. Abrams, 495 F. 2d 724, 730 (9th Cir. 1974); Myzel v. Fields, 386 F. 2d 718, 735 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968); Kohler v. Kohler, 319 F. 2d 634 (7th Cir. 1963). Our court has, on some occasions, imposed a "scienter or conscious fault" requirement."* *See* Clegg v. Conk, 507 F. 2d 1351, 1361-1363 (10th Cir. 1974), *cert. denied,*, 422 U.S. 1007 (1975). If the negligence standard were being applied it might be appropriate to allow due diligence to be exacted from the victim, but where liability of the defendant requires proof of intentional misconduct, the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated. On the other hand, if a

*It has also on occasion held that a negligence standard is sufficient. *See* Financial Industrial Fund, Inc. v. McDonnell Douglas Corporation, 474 F.2d 514 at 521 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973).

defendant is being subjected to liability even when he has not knowingly misrepresented but has been negligent, it is not unreasonable to hold a plaintiff to a similar standard. 2 Bromberg, Securities Law: Fraud Section 10b-5, Section 8.4 (652) (1974), states:

> It is noteworthy that the circuits which have most clearly charged defendant with constructive knowledge are, by and large, the same courts that have similarly charged plaintiff. There is a logic and balance in this. A high standard of conduct for defendant justifies a high standard for plaintiff. Stated a little differently, the price plaintiff pays for being relieved of the burden of proving defendant's intent or actual knowledge, is that plaintiff himself must show some diligence.

Thus, the limiting and narrowing of liability in the negligent misrepresentation case would be less illogical and the defense of due diligence tends in such a case to assume a more rational basis. *See* Comment, Negligent Misrepresentations Under Rule 10b-5, 32 CHI.L. Rev. 824, 841-42 (1965).[2] As we will see, however, this analysis is at present academic.

A significant clarification has taken place in this body of law as a result of the Supreme Court's recent decision in Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976). Prior to this decision there had been a division in the circuits as to the need for proving scienter. *Ernst &*

[2]Notwithstanding the reasonableness and the balance of the negligence analysis, it should be noted nevertheless that it is a trap for the unwary plaintiff because it becomes harder for him to recover if he has to overcome his own lack of due diligence. He gives up more than he gains from having the easier standard of negligence on the part of the defendant. The overall result is a substantial narrowing of the civil remedy.

Ernst, supra, has settled this conflict by holding that proof of negligence is not enough in a 10b-5 action; that such an action will not lie in the absence of an allegation and proof of scienter, the same being an "intent to deceive, manipulate, or defraud." 96 S. Ct. at 1381. Ernst & Ernst, an accounting firm, periodically audited the books of a brokerage house, the president of which perpetrated a fraudulent securities scheme. Customers who had invested in this scheme sued Ernst & Ernst under Section 10b and Rule 10b-5, claiming that it had aided and abetted the fraud by its negligent failure to conduct efficient audits. The district court rejected this negligence theory and granted summary judgment in favor of Ernst & Ernst. In the court of appeals the cause was reversed, the appellate court holding that negligence was a proper basis for liability under Rule 10b-5. It said that if the fraud could have been discoverable or preventable in the absence of negligence, the accounting firm became liable. The Supreme Court disagreed. Its holding was that only intentional conduct of the defendant could give rise to a recovery under Rule 10b-5. The majority of the court said that the use by the framers of Section 10b of the words "manipulative or deceptive" in conjunction with "device or contrivance" effectively showed an intention to allow recovery only where intentional conduct was present. In addition to its reliance on the language of the Act and rule, the court cited legislative history of the 1934 Act together with its relationship to the Securities Act of 1933.

The importance of *Ernst & Ernst* in the present case is that it calls for scrutiny of the defense of due diligence and prompts the question whether it applies to these facts even if it is applicable to more extreme circumstances. Since the plaintiff must prove his case in terms of the standard of scienter, doubts are cast on its usefulness where it allows the fraudulent actor to escape liability by saying that if the plaintiff had been diligent, he would

not have allowed himself to be cheated. If plaintiff must prove scienter and at the same time the defendant is allowed to defend on this basis, the general effect on the remedy is of great magnitude and the action lies only in an extraordinary case. Even in the exceptional case the defendant would likely be able to demonstrate some lack of diligence on the part of the plaintiff. If contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendant.

II

THE COMMON LAW TORT ANALOGY

Another important result of the Ernst & Ernst decision is that it brings the standards for 10b-5 liability closer to the analogous tort of deceit or intentional misrepresentation. The analogizing to tort law in fashioning standards for 10b-5 is instructive and useful. It is, in addition, supported by strong precedent. *See for example* Straub v. Vaisman and Company, Inc., Nos. 75-1704, 75-2018 (3d Cir. filed June 15, 1976); List v. Fashion Park, Inc., 340 F. 2d 457 (2d Cir.), *cert. denied sub nom.,* List v. Lerner, 382 U.S. 811 (1965); 3 Loss, Securities Regulation 1759-1763, 6 Loss, pp. 3880Off; Comment, Negligent Misrepresentations Under Rule 10b-5, 32 Chi.L.Rev. 824, 828-33 (1965).[3] While, therefore, where the defendant is charged with negligent misrepresentation, and where he is charged with intent to defraud, mere contributory negligence of plaintiff becomes trivial in comparison. Prosser, Law of Torts, 4th ed. Section 107 states:

> [W]here there is an intent to mislead, it is clearly inconsistent with the general

---

[3]The 10b-5 wrong is in nature and character a statutory tort in that it inflicts an injury of the same nature as a common law tort. The 10b-5 definitions are taken from the common law deceit definitions.

> rule [footnote omitted] that mere negligence of the plaintiff is not a defense to an intentional tort. The better reasoned cases [footnote omitted] have rejected contributory negligence as a defense applicable to intentional deceit . . .

Prosser, Section 108, p. 716.

Similarly, plaintiff is not duty-bound to investigate the truth or falsity of an intentional misrepresentation unless the misrepresentation is patently false. Restatement of Torts (1938) Sections 540, 541.[4] The Comment to Section 540 states that a person who has made a false statement about his financial condition may not defend on the ground that he offered to submit the books for inspection and that the offer was rejected. *See* Comment (a) to Section 540. Usually such an offer would not prevent the fraud anyway. Thus, where there has been intentional misrepresentation the common law does not exact a duty of due care or due diligence from the injured plaintiff.

Use of the tort analogy plainly demonstrates the inappropriateness of due diligence in 10b-5 suits under the *Ernst & Ernst* doctrine, for the due diligence standard as applied to 10b-5 suits is about the same as the application of contributory negligence. Just as

---

[4] These sections are as follows:

> Section 540: The recipient in a business transaction of a fraudulent misrepresentation of fact is justified in relying upon its truth, although he might have ascertained the falsity of the representation had he made an investigation.
>
> Section 541: The recipient in a business transaction of a fraudulent misrepresentation is not justified in relying upon its truth if its falsity is obvious.

contributory negligence is not a defense to an intentional tort case of fraud, similarly due diligence is totally inapposite in the context of intentional conduct required to be proved under Rule 10b-5.

Further support for this conclusion is found in the statutory language upon which the Supreme Court in *Ernst & Ernst* placed reliance in determining that the Act was meant to proscribe intentional conduct only. Nothing in the wording of either the statute or the rule suggests that a plaintiff is to be barred by failure to exercise due care or due diligence. Nor is there evidence that the framers of 10b-5 intended due diligence to be applicable any more than it had been applied to common law fraud.

We are not saying that once the plaintiff has proven scienter on the part of the defendant that he has discharged his requirements. Plaintiff must show that he relied on the misrepresentations and that the reliance was justifiable. Prosser, *op. cit.* Section 108; Restatement of Torts (1938) Section 541. And a plaintiff may not reasonably or justifiably rely on a misrepresentation where its falsity is palpable. This is another way of saying that the defendant's wrong must have been the cause of the plaintiff's harm. In the 10b-5 actions, as in common law fraud, there must exist this causal connection between the misrepresentation or nondisclosure and the plaintiff's injury.

III

CAUSATION OR JUSTIFIABLE RELIANCE

The Second Circuit has held scienter to be an essential element in a civil action under Rule 10b-5. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F .2d 228, 238-239 (2d Cir. 1974). The scienter element here required furnishes a basic element of causal connection which imposes a limitation on the defendant's liability.

Globus v. Law Research Service, Inc., 418 F.2d 1276, 1292 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970). The causal relationship provided by proof of reliance or materiality sufficiently satisfies the need for causal link. Titan Group, Inc. v. Faggen, 513 F.2d 234 (2d Cir.), *cert. denied,* 96 S,Ct, 70 (1975).

The Supreme Court in Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972), considered the reliance element in the 10b-5 action. Its decision was that where the deceit arose from nondisclosure, proof of reliance was unessential. A bank had purchased securities from a group of unsophisticated investors and had failed to disclose that the securities were being sold at a higher price in a market made by the bank. The court of appeals had ruled that the plaintiffs could not recover for failure to prove reliance. *See* Reyos v. United States, 431 F.2d 1337 (10th Cir. 1970). The Supreme Court reversed the Circuit Court and said:

> [u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. * * * This obligation to disclose and the withholding of a material fact establish the requisite element of causation in fact.

406 U.S. at 153-154.

Under the circumstances of that case, involving primarily a failure to disclose, the effect of the Supreme Court's ruling is, then, not to eliminate reliance as an element but rather to recognize the difficulty of proving

reliance in a failure to disclose situation. In this nondisclosure situation, once causal connection is proven by showing materiality, that is to say, whether a reasonable investor would have considered the withheld facts important, Affiliated Ute Citizens of Utah v. United States, *supra;* List v. Fashion Park, *supra,* the reliance element is inferred. Titan Group, Inc. v. Faggen, *supra,* at 238-239; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, *supra,* at 239-40; *see generally,* Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 Harv.L.Rev. 584 (1975).

Where, as here, there are affirmative misrepresentations, the problem of proving reliance is not the same and reliance is the appropriate and decisive way to prove the chain of causation. *Titan Group, supra; see also* Note, 88 Harv.L.Rev. 584 (1975). Unquestionably the proof of reliance or materiality is essential to the case where it is a positive misrepresentation type of action and justifiable reliance is the required element. Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975) (semble). All of this, however, is quite different from superimposing on the plaintiff the standard of due care. Under that standard the plaintiff would not be heard to say that he relied on misrepresentations which were obviously false.

Our court also requires proof of causation as a condition to recovery. *See for example* Financial Industrial Fund, Inc. v. McDonnell Douglas Corporation, 474 F.2d 514, 517, 521 (10th Cir.), *cert. denied,* 414 U.S. 874 (1973) (plaintiff must "demonstrate reliance on the acts or inaction of the defendant"); Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied,* 422 U.S. 1007 (1975) ("something more by way of reliance or causation in fact than some abstract wrong expending its force entirely upon itself" is required). Reliance does not flow from a showing of some abstract wrong. Plaintiff is obligated to prove his reliance and must also prove that it is justifiable.

The requirement of causation as an element in a 10b-5 case does not conflict with this court's decision in Mitchell v. Texas Gulf Sulphur, 446 F.2d 90 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971), *rehearing denied,* 405 U.S. 918 (1972), a case on which the defendant-appellant here relies.[5] Plaintiff there had claimed reliance on a press release which had been issued on April 13, 1964. A corrective release was issued April 16, 1964. Some five days after the correction, plaintiff sold Texas Gulf shares relying on the April 13 release. In holding that plaintiff's recovery was barred, the court indeed did refer to failure to exercise due diligence. However, the gravamen of the decision was that in the circumstances plaintiff's reliance on a week-old release which had theretofore been corrected was unreasonable and was not a justifiable reliance. It was said:

> [a]t some point in time after the publication of a curative statement such as that of April 16, stockholders should no longer be able to claim reliance on the deceptive release, sell, and then sue for damages when the stock value continues to rise.

446 F.2d at 103.

Mitchell also held that the corporation's liability for the press release ought to have been limited because such a release makes a limited impact and after awhile, given the fact that the human memory is fallible, could not be a basis for justifiable reliance, so in effect the court was applying the justifiable reliance standard.

In the instant case the trial court found specifically that the Holdsworths relied on Strong's statements. *See*

[5]Strong relies on two other Tenth Circuit cases as well. Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970); Financial Industrial Fund, Inc. v. McDonnell Douglas Corporation, 474 F.2d 514 (10th Cir. 1973). None of the three cases on which he relies support his position.

Findings of Fact 26, 33, and in Finding 29 the court found that reliance was justifiable. The trial court's findings are as follows:

> 26. Plaintiff K. Jay Holdsworth discussed his conversation with defendant [Strong] and this letter with his wife plaintiff Dona S. Holdsworth, and in reliance upon the representations made by defendant and their effect upon the apparent value of their shares, were induced to and did sell their stock to defendant.
>
> 29. Although plaintiff K. Jay Holdsworth was a Director and Secretary of Sans-Copy at the time plaintiffs agreed to sell their stock to defendant and made no demand to examine the books and records of Sans-Copy before selling his stock, his failure to do so was excusable under the facts and circumstances of this particular case and in view of the relationship of the parties. They were best of friends. They were engaged in another business, a ranch, which was supervised by plaintiff K. Jay Holdsworth as to which plaintiff K. Jay Holdsworth kept defendant fully informed of material developments and they were associated in their church and in bar activities and in publications.
>
> 33. The evidence is clear and convincing that false representations were made concerning present existing material facts which representations were made for the purpose of inducing the plaintiffs to sell their stock and that the plaintiffs

> did sell their stock, acting reasonably under the circumstances and in ignorance of the falsity of said representations and that the plaintiffs in fact relied upon said representations and were thereby induced to sell their stock.

While it is true that Holdsworth was the business associate of Strong as well as a close friend and the shareholding was in a closely held corporation, it cannot be said that the reliance on Strong's honesty was not justified particularly considering that the relationship was of long standing and particularly close so as to be one which was quasi-fiduciary. *See* Bird v. Ferry, 497 F.2d 112 (5th Cir. 1974).

We then conclude that the court's findings that the Holdsworths' reliance on Strong's misstatements was reasonable and justifiable and a causal link between Strong's conduct and the injury was supported. Even given the fact that Holdsworth was experienced or sophisticated, his reliance on Strong's honesty and integrity was justified when the extensive buildup to the transactions starting in the 1970s is considered. Strong was allowed to manage the corporation while Holdsworth was preoccupied with the ranch. Holdsworth was not placed on notice that his trust in Strong had been misplaced and so, throughout, the relationship between the parties had a fiduciary character.

Not only were Holdsworth and Strong business friends, their friendship extended as well to their families. This explains why Holdsworth failed to challenge Strong's representations every step of the way including the instance of the purchase by Strong of the stock. This trust and confidence had been carefully built up over a long period of time and had brought about the sale of the stock by means of long-range machinations. These factors furnished justification for the court to find that at

the time of the sale of the stock Holdsworth was conditioned. In view, then, of the existence of justifiable reliance and considering the added fact that an examination of the corporation's books would not have revealed the falsity of Strong's representations, we conclude that in the particular factual climate justifiable reliance was a link sufficient to eliminate a need for the Holdsworths to show lack of contributory fault.

IV

THE ARGUMENT THAT PROOF OF DAMAGES WAS ESSENTIAL

Strong's damage point is that plaintiff in a rescission case must prove damages with the degree of particularity which is demanded in an action for damages. We disagree. True, the plaintiff must establish his injury; obviously, the court is not engaging in the process merely to vindicate a principle. Plaintiff must show that he is injured and aggrieved in order to move the court to grant rescission. But the evidence does show that the Holdsworths did suffer property injury at the hands of Strong. They were induced to relinquish participation in an enterprise which would have yielded dividends had it not been for the diversion of funds. They were deprived of interest in a capital enterprise that had both growth potential and profit potential. Thus, the misrepresentations from the inception carried an impact.

In Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973), we were required to consider the measure of damages in a rescission action; at the same time, we recognized that the ordinary consequence of rescission is return of the property. We added: "But the real estate had been sold to a bona fide purchaser; hence the next best solution was to give plaintiff the proceeds. Plaintiff was entitled to the fair value of his interest at the time of the unlawful merger." While this case recognized the need for a

showing of injury in a rescission suit, it holds that damages are recoverable where the property is not available to be returned. This court's decision (opinion by Judge Hill) in Esplin v. Hirschi, 402 F .2d 94 (10th Cir. 1968), *cert. denied,* 394 U.S. 928 (1969), recognized the victim's option to claim rescission or damages in a 10b-5 suit. In that case it held that out of pocket loss was the proper measure where the plaintiff chooses damages. It inferentially noted that no particular damage proof had to be followed in a rescission. The buyer there would relinquish the stock and his purchase money would be refunded.

V

THE ISSUE OF MATERIALITY

In Finding of Fact 33 the trial court found that Strong's misstatements were material (Finding 33 is quoted *supra*). In effect it states that false representations were made concerning present facts which caused the Holdsworths to act and thus were material.

Strong argues that all of the alleged misrepresentations pertained to dividends and Strong's statement was that the company was not apt to pay dividends in the future. He says that inasmuch as the common stock never did pay dividends that this fact was incapable of causing the Holdsworths to sell their stock and hence were not material. However, the thrust of the fraud was to convince Holdsworth that neither the company nor its stock had worth; that it was too poor to pay dividends. This was false and this was material because it persuaded the Holdsworths to sell their common stock for a pittance. The trial court found that the misrepresentations as to the ability of the company to pay dividends was for the purpose of inducing plaintiffs to sell their stock and they did sell it for the low price, as

we have already noted. Gross receipts of the company at that time were extremely high; falsity was thus proved.

The materiality of these misrepresentations concerning the corporation's ability to pay dividends cannot be challenged. The falsity of these representations is supported by the record and the trial court's findings of fact and conclusions of law are fully supported. We recognize that the materiality of the misrepresentations is essential to a 10b-5 recovery and to a common law fraud recovery as well. *See* Mitchell v. Texas Gulf Sulphur, *supra*. The position of the trial court that the representations were material in that a reasonable investor would have considered them in making a decision is not erroneous. *See* Affiliated Ute Citizens of Utah v. United States, *supra*, and *see* List v. Fashion Park, Inc., *supra*. Unquestionably a reasonably investor would be interested in the company's future prospects in deciding whether he should sell his stock. If it is not going to pay any dividends or is not capable of paying any dividends, this would be a material consideration. It is hard to understand how the representation that a company has no earning power is to be regarded as non-material where it is given in order to induce the seller to sell.

VI

COMMON LAW FRAUD

In challenging the recovery based on common law fraud, appellant argues that Holdsworth could not have justifiably relied on misrepresentations of Strong in support of a common law fraud case. This is another way of saying that the representations were not material or did not cause the injury. We hold, however, that this element and all of the elements of common law fraud as they are defined by the Supreme Court of Utah are satisfied. The trial court's findings and conclusions on

this are correct and should be upheld. Johnson v. Allen, 108 Utah 148, 152, 158 P .2d 134, 137, enunciates the elements of common law fraud among which is reliance. It is there termed the right to rely. We are unable to see any difference between this and justifiable reliance. Noteworthy also is the fact that the court in Johnson v. Allen, *supra*, said that the law will seldom allow a plea of contributory negligence to a willful wront. *See* 108 Utah 153.

The record in this case shows that Strong used deceitful means in order to gain full and complete control of the Sans-Copy Corporation, having used fraud and deception to induce the Holdsworths to sell their stock for an amount grossly less than its actual value. They are not to be heard to say that the Holdsworths ought not to have trusted Strong; that they had no right to rely upon what he said and did. The fact is that they did trust him and they did rely upon his statements and their reliance was justifiable in view of the closeness of their relationship.

Accordingly, the judgment of the district court should be and the same is hereby affirmed.

SETH, Circuit Judge, concurring specially:

The litigation is between two of the three (or perhaps now two) stockholders of a local corporation. The parties are lawyers who started the business; they are directors of the corporation, and the plaintiff is also a C.P.A. and an officer of the corporation. The parties were close friends and associates. The sale was of a large part of the outstanding stock.

This is certainly not the situation or transaction contemplated by the courts which fashioned the remedy under Rule 10b-5, and it probably does not come within Rule 10b-5 anyway. It is no more than a common law fraud case. Thus I concur in division VI of Judge Doyle's

opinion, and would affirm the trial court on that ground alone.

HILL, Circuit Judge, concurs in Judge SETH's specially concurring opinion.

BARRETT, Circuit Judge, specially concurring:

I believe that the thread is too thin to hold the facts of this case to the manipulative and deceptive devices proscribed by Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j (b) and Rule 10b-5 of the Commission, 17 CFR 240 10b-5. Reliance can only be had upon one letter submitted by Strong to Holdsworth wherein Strong represented that the corporation would never pay dividends in the future. That was an untrue statement. In addition, Strong omitted to state a number of material facts. Both because the thread is so thin and in light of the close relationship between the three stockholders, I agree with Judge Seth's view that this is not the type of security transaction contemplated for remedial purposes under Rule 10b-5.

I, too, concur in part VI of Judge Doyle's opinion, relying upon these specific findings of the trial court: (a) that the Holdsworth sale of his stock to Strong, although made without examination of the corporate books and records, was excusable in view of the close relationship - friendship between them, coupled with the fact that Strong did not keep accurate or complete books and records, and (b) that even had Holdsworth examined the books and records of the corporation kept by Strong, they would not have revealed the falsity of Strong's representations.

In concurring, I believe it is important to point out certain defaults on the part of Holdsworth. He was a practicing attorney, an accountant and a businessman who was no stranger to business transactions and legal entanglements. He knew "the ropes". Holdsworth was a

director, officer and stockholder of Sans-Copy. Title 16-10-33, Utah Code Annot., Replacement Vol. 2B (1953) provides, *inter alia*, that the business and affairs of a corporation shall be managed by the board of directors. Title 76-13-8, Utah Code Annot., Vol. 8 (1953) provides that every director of a corporation is deemed to possess such a knowledge of the affairs of his corporation as to enable him to determine whether any act, proceeding or omission of its directors is a violation of Chapter 13 entitled "Corporation Frauds". The term "director" embraces any of the persons having by law the direction or management of the affairs of a corporation. Title 76-13-12, Utah Code Annot., Vol. 8 (1953).

Holdsworth did not perform the duties imposed upon him under the laws of Utah as a director and officer of the corporation. His default was, in large measure, an invitation for the fraud practiced upon him. Holdsworth's professional and business background was such that he was familiar with corporate affairs; he was familiar with financial reports, statements and accountings; and, almost certainly, he knew that the internal financial reports of a corporation could be and often are "doctored" so as to fail to disclose the true facts and that an independent audit would disclose the true state of affairs. It is only in reliance of the two specific trial court findings heretofore referred to that I am willing to accede that Strong's intentional fraud bars him from avoiding the liability imposed. A word of caution is in order. While "negligence" and "fraud" are not legally equivalent terms, still the circumstances of each case must be carefully considered. In a proper case negligence may be so gross as to take the place of a deliberate intention to work a fraud.

APPENDIX E

NOVEMBER TERM - November 16, 1976

Before The Honorable Delmas C. Hill, The Honorable Oliver Seth, The Honorable William J. Holloway, Jr., The Honorable Robert H. McWilliams, The Honorable James E. Barrett and The Honorable William E. Doyle, Circuit Judges

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Plaintiffs-Appellees,

vs. No. 75-1144

KLINE D. STRONG,
Defendant-Appellant.

SECURITIES AND EXCHANGE
COMMISSION,
Amicus Curiae.

This matter comes on for consideration of appellant's petition for rehearing filed in the captioned cause.

Upon consideration whereof, the petition for rehearing is denied.

/S/______________

HOWARD K. PHILLIPS
Clerk

IN THE

Supreme Court of the United States

76-1119

No. 76-119

KLINE D. STRONG,
Petitioner,

vs.

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

SNOW, CHRISTENSEN
& MARTINEAU

Harold G. Christensen

7th Floor
Continental Bank Bldg.
Salt Lake City, Utah 84111

Attorneys for Respondents

TABLE OF CONTENTS

TABLE OF CITATIONS

CASES CITED

OTHER AUTHORITIES CITED

IN THE

Supreme Court of the United States

No. 76-119

KLINE D. STRONG,
Petitioner,

vs.

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

STATEMENT OF THE CASE

This is an action commenced by respondents against petitioner for rescission of a sale of stock in a closely held Utah corporation. Respondents based their action on violations of Rule 10b-5, its enacting federal statute, and common law fraud under state law.

The District Court, sitting without a jury, found in favor of respondents on both the federal claims and on the state common law claims and ordered petitioner to return the stock to respondents. (Pet. App. B).

Petitioner appealed to the Tenth Circuit Court of Appeals where the case was argued before a panel of three circuit judges. In a two to one decision the Circuit Court

reversed the judgment of the trial court on both the federal 10b-5 claims and the common law fraud claims. (Pet. App. C).

Respondents petitioned and were granted a rehearing *en banc*. All seven judges of the Tenth Circuit Court of Appeals, except the Chief Judge, participated in rehearing. Of the six judges participating, all six affirmed the District Court's findings of common law fraud under state law. Three of the judges declined to join the majority opinion affirming the finding of liability under Rule 10b-5. (Pet. App. D).

Respondents adopt the findings of the Circuit Court of Appeals sitting *en banc* as the correct statement of facts. The Circuit Court of Appeals found the following:

"Plaintiff-Appellees prevailed in an action for rescission of a sale of stock. Appellant Kline D. Strong was found to have made the sale by using false representations and fraudulent devices. The suit was brought pursuant to Section 10b of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Recovery was also obtained on a parallel claim in common law fraud.

"The Holdsworths, husband and wife, sold their shares of stock in a closely held corporation called Sans-Copy to Strong, who had owned the majority of the stock in this corporation. Strong persuaded them to sell the stock, generally representing that the company was unable and would be unable to pay dividends. In truth, the company was continuously increasing its volume and had demonstrated earning capacity.

"The cause was tried to the court as an equity case, the Holdsworths' demand for a jury trial having been denied. It required four days to complete. At the end of the trial the judge announced from the bench that there was clear evidence of fraud of the elements of a common law fraud case under the law of Utah. He then set forth his findings in oral form. These were later incorporated in a formal set of findings of fact and conclusions of law which were signed December 1, 1974. Strong did not seek a new trial nor did he challenge the findings and conclusions in the trial court. Instead he appealed at once to this court.

"Both Kline D. Strong and the appellee K. Jay Holdsworth are attorneys; Holdsworth is an accountant as well. Paul Tanner, who was also a part of the enterprise in question, was and is an accountant. The mentioned parties formed the subject corporation. Its purpose was to develop, manufacture and sell time-keeping systems for law offices. Originally there were 60 shares of common stock which were divided equally among the three incorporators and their wives. Each couple paid $300 for 20 shares. It was contemplated at the outset that all three would participate in the management of the corporation. It did not work out as planned, however; Mr. Strong ended up in complete charge of the business. In its initial stages he performed research and other preliminary work developing the idea and introducing it to the legal profession. Essentially, it was a simple system for recording the time spent by lawyers working for clients.

"In July 1959, Sans-Copy entered into an agreement with Reynolds and Reynolds granting to the latter the exclusive right to manufacture and market the system

except in Utah. Under the agreement Sans-Copy was to receive a royalty of 30 percent on gross sales and Strong was to promote the time-keeping system at bar association conventions and meetings. It was as a result of this change of condition that the shares in the corporation were changed; Strong informed Holdsworth that since he was doing most of the work he believed that he should own a controlling interest. Holdsworth and Tanner agreed to this, and as a result Strong was given 52 shares of the 100 shares of the outstanding stock in the corporation.

"The details of the Sans-Copy process is not of primary importance, but a brief description will help general understanding. It was and is a method for recording and keeping records of the time spent by a lawyer on a client's case. It furnishes a daily log as well as separate slips to be sorted for use in determining bills. The system was intended to provide an easy way for lawyers to keep time sheets and to prevent double or triple entry accounting.

"Strong was being paid compensation for his efforts, and Holdsworth and Tanner were given some shares of newly created stock which provided for them to get a small dividend annually. These dividends were paid irregularly in the Class A common stock until 1970, at which time they were abruptly terminated. (Footnote omitted).

"After 1962, there were neither board meetings nor financial statements furnished to Holdsworth and Tanner. Holdsworth did not participate in the management of the corporation and his knowledge was restricted to information furnished by Strong.

"In 1971, Strong notified Holdsworth and Tanner that

the company had invaded capital in issuing 1970 dividends. For that reason they were told that no dividends would be forthcoming at that time.

"Holdsworth and Strong also owned a ranch, and subsequently, in January 1972, during the course of a conversation between Strong and Holdsworth having to do with the ranch, Strong offered to buy the Holdsworth shares for $1,500. Strong at that time represented to Holdsworth that the corporation would never pay dividends in the future. He repeated this oral statement in a letter to the Holdsworths a short time later. Based on that statement and others, the Holdsworths sold their shares for $1,500 and a general release. In the same year, Holdsworth learned that Sans-Copy had realized a gross income exceeding $100,000 and his knowledge moved them on May 17, 1973, to give notice of rescission. When Strong rejected this attempt, they started the present suit on May 31, 1973. Their claims were based on the following material representations and omissions (summarized and paraphrased hereafter):

"Strong's statement that it was unlikely that dividends would be paid in the future; that the corporation was unable to pay present or future dividends on the preferred shares; omission by Strong to state material facts necessary to render the statements non-misleading; that at the end of the fiscal year ending November 30, 1971, Sans-Copy had gross receips in excess of $96,000; gross receipts were increasing each year since 1969; Sans-Copy was a growing enterprise; deductions were unnecessarily excessive and improper and many of these were paid to Strong and his relatives; that Strong had borrowed from the corporation and not repaid the loans; furthermore, that the $1,500

was an unfair price in light of the earnings of the corporation and its growth potential. It was also alleged that Strong had employed schemes and devices to defraud, had engaged in acts, practices and a course of business which had operated as a fraud and had breached his fiduciary responsibilities to the Holdsworths, violating their special relationship of trust and confidence.

"After a trial to the court, it was ordered that Strong return the common stock and the reversions in the Class A common stock to the Holdsworths.

The Trials Court's Findings

"In the trial court's findings of fact and conclusions of law it was brought out that the Holdsworths and Strongs were close friends and that this had been an important element in their entering into the enterprise. The trial court also considered some of the excessive expenditures which had been made by Sans-Copy to Strong's law firm. Excessive loans made to Strong from Sans-Copy funds were detailed. Amounts paid to Strong's immediate family and payment of personal expenses to Strong from the funds of Sans-Copy without approval or authorization of Holdsworth or Tanner were pointed out as was payment of funds to Strong and his law firm in 1971 charged as attorney's fees but for which no legal services had been rendered.

"The court also found that:

"In 1970-71, the net worth of Strong was shown to have increased substantially; the defendant had misrepresented that there had been an invasion of capital in the payment of dividends in 1970.

"There was in fact a surplus for that year. During 1971, Strong had diverted a large sum of money from Sans-Copy to a non-profit corporation, Utah Law Research Institute, of which he was the organizer and executive director.

"In 1971, defendant diverted funds from Sans-Copy to make restitution to the profit sharing plan of his law firm; no legal services were rendered to Sans-Copy for this payment of $4,570.

"During the year 1971, the net worth of appellant Kline Strong increased $262,000 which, after adjustments claimed by appellant, showed an increase of $112,000.

"Notwithstanding the foregoing, the trial court found, appellant maintained that Sans-Copy was unable to pay dividends and would be unable to pay dividends in the future. Representations in Strong's letter to Holdsworth offering to buy him out were knowingly false statements relied on by the Holdsworth in accepting the offer to buy their stock.

"The sale of the stock without examination of the books was held to be excusable in view of the friendly relationship of the parties, being engaged in the ranching business together as well as Sans-Copy. The books and records, according to the further finding of the court, failed to accurately reflect the condition of the company; they were incomplete and had been adjusted and revised by the defendant. So examination would not have been helpful in learning the truth.

"The court determined that the eveidence was clear and convincing that false representations were made by

defendant concerning the present facts, which representations the defendant knew to be false and which representations were made for the purpose of inducing the plaintiffs to sell their stock and that the plaintiffs did sell their stock acting in reliance upon the representations made and in the belief that the representations were true.

"The court's conclusions of law emphasized that the defendant knowingly and intentionally made false representations of present existing facts concerning the shares of stock of Sans-Copy for the purpose of inducing plaintiffs to sell their shares, and the plaintiffs sold their shares in reliance on the representations and that they acted reasonably under the circumstances of the case and the relationship of the parties and in ignorance of the falsity of the representations. The court concluded that there had been a violation of Section 10b and Rule 10b-5 of the Securities and Exchange Act of 1934, all of which entitled the plaintiffs to restitution."

ARGUMENT

The Petition for Writ of Certiorari does not demonstrate any valid reason for review of the *en banc* decision by this Court.

The decision of the trial court can be sustained on state law grounds without consideration of the federal issues. Indeed the Circuit Court *en banc* unanimously affirmed the decision on state law grounds.

The "questions presented" by petitioner are based upon erroneous interpretations of the Tenth Circuit Court *en banc* opinion and upon erroneous interpretations of other

circuit and state court decisions. There is neither a conflict among the circuits, an important question of federal law which has not been settled by this Court, nor a conflict with the decisions of this Court. Petitioner attempts to characterize the *en banc* decision as involving novel legal theories while in actuality the Circuit Court merely applied well recognized and established judicial standards to what is essentially a factual dispute.

A. *The Tenth Circuit Court of Appeals Is Not In Conflict With Any Other Court Nor Has It Eliminated A Scrutiny Of A Plaintiff's Own Actions.*

The Tenth Circuit in its opinion stated the following:

> Inasmuch as the defendant does not challenge the general sufficiency of the evidence but rather bases his demands for reversal on alleged trial error, we address our comments to the specifics but, at the same time, *note in passing that substantial evidence of intentional fraud and deceit is present.* (Pet. App. D, p. 50) (Emphasis added).

The petitioner throughout the appellate process has not questioned the sufficiency of the evidence showing clear and intentional fraud. Rather, he claims that the Tenth Circuit and Third Circuit courts are in disagreement as to the standard to be applied to the conduct of the ones defrauded. There is no such disagreement.

Petitioner contends that *Straub v. Vaisman & Co., Inc.*, 540 F.2d 591 (3rd Cir. 1976) is in direct conflict with the Tenth Circuit *en banc* opinion. *Straub* concerned a security transaction between a German corporation and a New York securities broker-dealer. The trial court in *Straub* based

its decision on defendant's failure to disclose material information. 540 F.2d at 594. *Straub* is therefore factually distinguishable from the case at bar since the trial court in this case found that "defendant knowingly and intentionally made false and fraudulent misrepresentations." (Pet. App. A, p. 24). This Court has held that omission cases are judicially distinguishable from misrepresentation actions because of the differing elements of proof required in each type of case. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). Thus, it is highly questionable whether *Straub* is even properly comparable with the instant case. In any event, however, the *Straub* decision is not in conflict with the Tenth Circuit *en banc* opinion.

In *Straub* the trial court awarded the plaintiffs $38,000 and concluded that the actions of defendant were "shocking to the conscience of this Court." The Third Circuit Court characterized the defense presented as "defendant's [attempt] to focus solely upon the plaintiff's conduct and thus escape liability despite the intentional scheme to defraud." 540 F.2d at 596. There, as here, the defendants did not contest their fraudulent schemes but merely tried to shift responsibility to the plaintiffs for failing to discover those fraudulent schemes.

The Third Circuit Court recognized the scienter requirement set forth in *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976). Discussing the effect this requirement has upon the "due diligence" defense, the court stated:

> [S]ince *Ernst & Ernst v. Hockfelder*, supra, has limited 10b-5 actions to those in which the defendant has a mental state "embracing intent to deceive, manipulate or defraud" the desirability of a "contributory negligence" defense becomes less compelling. In determining the scope of the due diligence defense, we look to two considerations, common law derivations and deterrence of investor carelessness. 540 F.2d at 597.
>
> * * *
>
> The analogy to the common law torts indicates that since intent to defraud is a necessary element of a 10b-5 action, the due care defense should be narrowly circumscribed. Under the common law, once the right to recover for intentional misrepresentation has been established, lack of care on the part of the recipient in accepting the representations as true becomes irrelevant so long as the misrepresentation is not patently false. W. Prosser, Handbook of the Law of Torts §108 (4th ed. 1971); Restatement of Torts §§540, 541 (1938). Moreover, against the background of common law negligence, where the doctrine of comparative negligence is in the ascendency, the policy of denying all recovery to a defrauded plaintiff who was only somewhat careless or undestandably trusting may be questioned. *Id* at 597.

Similarly, in the Tenth Circuit Court of Appeals *en banc* opinion it is said:

> Use of a tort analogy plainly demonstrates the inappropriateness of due diligence in 10b-5 suits under *Ernst & Ernst* doctrine, for the due diligence standard as applied to 10b-5 suits is about the same as the application of contributory negligence. Just as contributory negligence is not a defense to an intentional tort case of fraud, similarly, due diligence is totally inapposite in the context of intentional conduct to be proved under Rule 10b-5. (Pet. App. D., pp. 55-56).

The Tenth Circuit Court in this case cited the *Straub* opinion in reaching its decision. (Pet. App. D, p. 54).

Both, the Third Circuit and Tenth Circuit Courts agree that due diligence has but limited, if any, application to intentional fraud cases.

The criteria used by both courts in reviewing a plaintiff's conduct are identical. The Third Circuit Court stated that the circumstances of each case must be carefully examined, and that the burden of proof rests upon the defendant to show unreasonable behavior on the part of the plaintiff, saying:

> Such matters as fiduciary relationship, opportunity to detect the fraud, sophistication of the plaintiff, the existence of long standing business or personal relationships, and access to the relevant information are all worthy of consideration. 540 F.2d at 598.

The Third Circuit, applying this standard, concluded that the trust of plaintiff in defendant's advice and the failure of plaintiff to have access to information "fully justifies the District Court's rejection of the lack of diligence defense." *Id.*

Similarly, the Tenth Circuit stated in its opinion that a plaintiff must be shown to have "justifiably relied" upon the fraud of a defendant and that a plaintiff "may not reasonably or justifiably rely on a misrepresentation where its falsity is palpable." In evaluating the justifiable reliance of a plaintiff, the court considered the same factors enumerated in *Straub*. The Tenth Circuit Court stated:

> Not only were Holdsworth and Strong business friends, their friendship extended as well to their families. This explains why Holdsworth failed to challenge Strong's representations every step of the way, including the insistence of the purchase by Strong of the stock. This trust and confidence had

> been carefully built up over a long period of time and had brought about the sale of the stock by means of a long-range machination. These factors furnished justification for the court to find that at the time of the sale of the stock Holdsworth was conditioned. In view, then, of the existence of justifiable reliance, and considering the added fact that an examination of the corporation's books would not have revealed the falsity of Strong's representations, we conclude that in the particular factual climate, justifiable reliance was a link sufficient to eliminate a need for the Holdsworths to show lack of contributory fault. (Pet. App. D, pp. 61-62).

Since the Third Circuit in *Straub* considered similar factors in evaluating the plaintiff's fault, it is highly probable that the Third Circuit would have reached the same conclusion in the instant case in view of the specific finding of the trial court that:

> Plaintiffs acted reasonably under the circumstances of this case and the relationship of the parties and in ignorance of the falsity of said misrepresentations. (Pet. App. A, p. 24).

The claimed conflict among the circuits is completely illusory.

Petitioner's alleged fear that imprudent investors will be able to recover under 10b-5 and that investment information will cease to be made available are also unfounded. (Pet., pp. 8-9). The Securities and Exchange Commission filed its *amicus curiae* brief in support of the respondents' request for rehearing by the circuit. It is thus apparent that the SEC is in favor of the decision as rendered by the *en banc* court and that the court's interpretation of the 1934 SEC Act is not erroneous as is asserted by petitioner in his brief. (Pet. p. 9). There can be no doubt that the

Tenth Circuit Court of Appeals is concerned with the actions of plaintiffs in 10b-5 cases and will carefully scrutinize these actions to see if a plaintiff's justifiable reliance and causation is present in a given factual situation.

Petitioner's "first question presented" should be rejected by this Court.

B. *The Tenth Circuit Court of Appeals Applied Correct Principles of Law in Reviewing Petitioner's Claim Concerning Proof of Damages.*

Petitioner claims that the Tenth Circuit Court of Appeals erred in holding "that a plaintiff need not demonstrate any pecuniary injury in order to sustain a claim for rescission in a civil action under SEC Rule 10b-5." (Pet. p. 2) This contention both misconstrues the holding of the Circuit Court and the applicable rule of law.

This action sought rescission of a sale of stock by the seller, not money damages. As such, respondents did not need to show the actual monetary damage suffered, so long as some injury or detriment was proven.

The Circuit Court of Appeals found that the evidence justified the trial court's conclusion of injury, in that respondents were induced "to relinquish participation in an enterprise which would have yielded dividends had it not been for the diversion of funds" and "were deprived of interest in a capital enterprise that had both growth potential and profit potential." (Pet. App. D., p. 62).

The cases relied upon by petitioner involve actions for damages, not for rescission. (Pet. p. 10). Obviously, in an action for money damages, a plaintiff must prove the amount of his damage. In rescission, however, such exactness is not necessary, since the stock itself is being sought and damage have been waived by the plaintiff in favor of the potential benefits to be gained by the repossession of the stock. The authorities agree that the amount of monetary damages need not be shown in rescission actions. Williston, *Contracts,* §1525; III Pomeroy, *Equity Jurisprudence,* §898 (§A), p. 535, 5th Ed.

Even the *Restatement of Torts* relied upon by petitioner (Pet. p. 10) is against his position. "Harm" is defined therein as the "existence of loss or detriment in fact of any kind to a person resulting from any cause." §7, p. 12. Both the trial court and the Circuit Court found sufficient evidence of harm to justify rescission.

Petitioner's "second question presented" should also be rejected.

C. *The Court of Appeals and Trial Court Properly Applied Utah State Law.*

As noted earlier, the *en banc* opinion unanimously held that petitioner had perpetrated common law fraud as defined by the Utah Supreme Court. Thus, regardless of any federal questions presented, the Circuit decision may be affirmed on this ground alone.

Petitioner claims that the court of appeals and trial court incorrectly applied Utah law to the claim of common law fraud. However, both the trial court and appellate court specifically found that all of the elements necessary to establish common law fraud under Utah law were present in the record (Pet. App. D., p. 64-65).

It is well settled that this Court should ordinarily accept the determination of state law made by the trial court and the court of appeals. *Commissioner of Internal Revenue v. Vouch,* 387 U.S. 456 (1967); *County of Allegheny v. Frank Mashuta Company,* 360 U.S. 185 (1959).

A recent Utah Supreme Court case succinctly states the law in cases where the carelessness of the plaintiff is claimed as a defense in actions based on actual fraud. The Utah Supreme Court stated:

> The law does not generally approve nor give any advantage to one who intentionally deceives another, obstructs him from learning the facts, and then attempts to impute fault and responsibility to the other party for believing him. *Bezner v. Continental Dry Cleaners, Inc.,* 548 P.2d 898 (Utah 1976).

The Utah Supreme Court, as illustrated by *Bezner,* has always examined the factual context of the claimed actions of a plaintiff to determine if justifiable reliance is present.

It is apparent that the Utah Supreme Court in applying Utah law would find a clear case of common law fraud because petitioner had undisputably concealed material facts from respondents, had misused respondents' trust and confidence in him, and had attempted to conceal all evidence of the perpetrated fraud. The trial court's determination that, in view of these circumstances, a common law fraud case existed is supported by the record and by the decisions of the Utah Supreme Court.

For these reasons, petitioner's third and final questions presented should also be rejected.

CONCLUSION

For the reasons set forth above, the respondents respectfully submit that petitioner has failed to raise any issues meriting review by this Court. This case is essentially a factual dispute. It was resolved on state law grounds. The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

SNOW, CHRISTENSEN &
MARTINEAU

Harold G. Christensen

Attorneys for Respondents